1963

Unofficial answers to the Uniform certified public accountants examination, May 1960 to November 1962

Edward S. Lynn

American Institute of Certified Public Accountants

UNIFORM CPA EXAMINATION • ANSWERS • 1960—1962

UNOFFICIAL ANSWERS

.....TO THE UNIFORM CERTIFIED

PUBLIC ACCOUNTANTS EXAMINATION

MAY 1960 TO NOVEMBER 1962

UNOFFICIAL ANSWERS

To the Uniform Certified

Public Accountant Examinations of

the American Institute of Certified Public Accountants

MAY 1960 to NOVEMBER 1962

By Edward S. Lynn

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FOREWORD

The text of the Uniform Certified Public Accountant Examinations, prepared by the Board of Examiners of the American Institute of Certified Public Accountants and adopted by the examining boards of 50 states, the District of Columbia, Puerto Rico, and the Virgin Islands, are periodically published in book form. Unofficial answers to these examinations appear twice a year as a supplement to THE JOURNAL OF ACCOUNTANCY. These books have been used in accounting courses in schools throughout the country, and have proved valuable to candidates for the CPA certificate.

Responding to a continuing demand, we now present a book of answers covering the period from May 1960 to November 1962. The problems and questions of this period appear in a separate volume which is being published simultaneously. It cannot be too strongly emphasized that these answers are not in any sense official. They represent merely the opinion of Edward S. Lynn, Director of Education of the American Institute, who has prepared them for publication.

JOHN L. CAREY, *Executive Director*
American Institute of Certified Public Accountants

April 1963

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ACCOUNTING PRACTICE—PART I

May 19, 1960; 1:30 p.m. to 6:00 p.m.

Solution 1

a. Entries required to record the transactions and close the books of Houston Factors, Inc., as at March 31, 1960 were:

		Debit	*Credit*
(1)	Cash	$1,000,000	
	Capital stock		$1,000,000
	To record sale of capital stock		
(2)	Accounts receivable	900,000	
	Commission income		18,000
	Client reserve		90,000
	Cash		792,000
	To record the purchase of client accounts receivable for January, February and March		
(3)	Provision for bad debts	2,250	
	Allowance for bad debts		2,250
	To set up provision for bad debts based on one-fourth per cent of accounts receivable factored		
(4)	Cash	700,000	
	Accounts receivable		700,000
	To record collections on accounts receivable		
(5)	Client reserve	70,000	
	Cash		70,000
	To adjust the client reserve to 10 per cent of unpaid receivables as at March 31		
(6)	Commission income	4,000	
	Unearned commissions		4,000
	To set up unearned commissions at March 31 based on 2 per cent of uncollected receivables		
(7)	Salaries	5,000	
	Office rent	900	
	Advertising	500	
	Equipment rent	1,600	
	Miscellaneous	1,000	
	Cash		9,000
	To record payment of general and administrative expenses		

		Debit	Credit
(8)	Cash	500,000	
	Notes payable		500,000
	To record the bank loan		
(9)	Interest expense	5,000	
	Accrued interest payable		5,000
	To accrue interest on bank loan at 6 per cent for two months		
(10)	Office furniture and fixtures	5,000	
	Accounts payable		5,000
	To record purchase of office furniture and fixtures		
(11)	Deficit incurred to date	2,250	
	Commission income	14,000	
	Salaries		5,000
	Office rent		900
	Advertising		500
	Equipment rent		1,600
	Miscellaneous		1,000
	Provision for bad debts		2,250
	Interest expense		5,000
	To close out income and expense accounts as of March 31, 1960		

b.

HOUSTON FACTORS, INC.

Balance Sheet

March 31, 1960

Assets

Current assets		
Cash		$1,329,000
Accounts receivable	$ 200,000	
Less allowance for bad debts	2,250	197,750
Total current assets		1,526,750
Office furniture and fixtures		5,000
Total assets		$1,531,750

Liabilities and Stockholders' Equity

Current liabilities		
Notes payable		$ 500,000
Accounts payable		5,000
Accrued interest payable		5,000
Client reserve		20,000
Total current liabilities		530,000
Unearned commissions		4,000
Stockholders' equity		
Capital stock—authorized and issued 100,000 shares of $10 par value each	$1,000,000	
Less deficit incurred to date	2,250	997,750
Total liabilities and stockholders' equity		$1,531,750

Statement of Income and Expenses

For the Three Months Ended March 31, 1960

Commission income		$ 14,000
General and administrative expenses		
Salaries	$ 5,000	
Office rent	900	
Advertising	500	
Equipment rent	1,600	
Provision for bad debts	2,250	
Miscellaneous	1,000	11,250
Net profit from operations		2,750
Interest expense		5,000
Net loss for the period		$ 2,250

Solution 2

1. **THE RICKARD COMPANY**

Reconciliation of Bank Balances and Cash Accounts

March 31, 1960

		Central Bank		*State Bank*	
		Per Books	*Per Bank*	*Per Books*	*Per Bank*
Balance, March 31, 1960		$16,558	$14,415	$ 4,629	$7,509
Add: Note collected by bank				1,900 (e)	
Deposit in transit			713		
Check of Richard Co. erroneously charged by bank			87		
Error in posting				270 (a)	
Error in entering checks Nos. 639 and 1080		(628) (f)		628 (f)	
Error in entry of deposit		713 (i)		(713) (i)	
		16,643	15,215	6,714	7,509
Less: Error in footing cash receipts		100 (a)			
Checks not previously entered		325 (b)		70 (j)	
Note of R. Walbert dishonored and charged back		1,013 (c)			
Protest fee re NSF check				3 (d)	
Error in entering check No. 1082				10 (g)	
Bank charges		7 (h)		4 (h)	
Outstanding checks:					
No. 629	17				
640 (certified)	—		17		
No. 1083	200				
1085	612				
	70				882
		1,445	17	87	882
Adjusted balance, March 31, 1960		$15,198	$15,198	$ 6,627	$6,627

2.

JOURNAL ENTRIES

March 31, 1960

				Debit	*Credit*
(a)	Cash—State Bank			$ 270	
	Cash—Central Bank				$ 100
	Exchange				170
	To correct the following errors:				
	Error in addition in March cash receipts—Central Bank		$100		
	Error in posting of March cash disbursements:				
	Cash—State Bank posted as	$4,968			
	Should be	4,698	270		
	Difference		$170		
(b)	Selling expense			325	
	Cash—Central Bank				325
	To record checks not previously entered:				
		$150			
		175			
		$325			
(c)	Accounts receivable—R. Walbert			1,013	
	Notes receivable discounted			1,000	
	Cash—Central Bank				1,013
	Notes receivable				1,000
	To record payment of R. Walbert's note, discounted and subsequently dishonored				
(d)	Bank charges (or Accounts receivable—B. Hillman)			3	
	Cash—State Bank				3
	To record a protest fee on NSF check				
(e)	Cash—State Bank			1,900	
	Notes receivable				1,900
	To record the collection of Mueller & Co. note receivable by the State Bank				
(f)	Cash—State Bank			628	
	Cash—Central Bank				628
	To correct entry of the following checks:				
	No. 639—Entered as State Bank; should be Central Bank		$845		
	No. 1080—Entered as Central Bank; should be State Bank		217		
	Difference		$628		
(g)	Office furniture			10	
	Cash—State Bank				10
	To correct entry of check No. 1082:				
	Cleared as	$220			
	Entered as	210			
	Difference	$ 10			
(h)	Bank charges			11	
	Cash—State Bank				4
	Cash—Central Bank				7
	To record March collection and exchange charges				
(i)	Cash—Central Bank			713	
	Cash—State Bank				713
	To correct entry of March 31, 1960 deposit				
(j)	Selling expense			70	
	Cash—State Bank				70
	To record a check not previously entered				

Solution 3

Computation of Net Income from Practice

Professional receipts		$20,000
Less professional expenses		
Wages paid receptionist	$4,000	
Office rent	1,000	
Drugs and supplies	3,985	
Other professional expenses	400	
Depreciation on 1957 automobile	340	
Personal property tax	15	
Depreciation on 1959 automobile (see Schedule I)	750	10,490
Net income		$ 9,510

Computation of Adjusted Gross Income

Net income from practice			$ 9,510
Income from dividends			
Beneficial Mutual Life Insurance Co.		$ 300	
Union Pacific Railroad Co.	$250		
Less dividend exclusion	50	200	500
Income from interest			
Federal Savings & Loan		120	
Series E—U. S. Savings Bonds		80	200
Income from rents and royalties			
Oil and gas royalty		1,000	
Less 27½% depletion		275	725
Other income			
Directors fees—XYZ Corporation			400
Gain from sale of capital assets			
Canyon Uranium (see Schedule II)			500
Loss from property other than capital assets			
1957 automobile (see Schedule III)			(130)
Adjusted gross income			$11,705

Note: Dividend received on National Service Life Insurance Policy ($60) and interest on Murray City Bonds ($50) are not subject to tax.

Computation of Deductions from Adjusted Gross Income

Interest paid on home mortgage	$ 200
Contribution—Church	100
Contribution—Community Chest	50
Property taxes—home	150
Sales taxes on personal expenditures	50
Utah state income taxes	100
Medical expenses ($400 — 351)	49
Itemized deductions allowable	$ 699
Standard deduction allowed	$ 1,000

Computation of Taxable Income

Adjusted gross income	$11,705
Standard deduction allowed	1,000
	10,705
Deduction based on number of exemptions (600 × 4)	2,400
Taxable income	$ 8,305

SCHEDULE I

Computation of Depreciation on 1959 Automobile

Original cost	$3,750
Salvage	0
Estimated useful life (per bulletin F)	5 years
Method of depreciation	Declining — Balance*
Date of acquition	7/1/59

Depreciation expense for 1959
$3,750 × 40% × 6 mos. = $750

*The declining-balance method produces a larger deduction in 1959 than either straight-line or sum-of-the-years digits.

SCHEDULE II

Computation of Gain on Sale of Capital Asset

Description	1,000 shares Canyon Uranium
Date acquired	2/28/59
Date sold	8/29/59
Sales price	$1,500
Cost basis	500
Long-term capital gain	1,000
Less 50%	500
Net long-term capital gain	500

SCHEDULE III

Computation of Loss on Sale of Property Other than Capital Assets

Description	1957 automobile
Date acquired	3/1/57
Date sold	6/21/59
Gross sales price	$1,850
Depreciation allowed	1,670
Cost basis	3,650
Loss on sale of automobile	130

Solution 4

a. **ANALYSIS OF REAL ESTATE**

	Recorded as Real Estate	*Land*	*Building*	*Good-will*	*Ex-pense*	*Option*	*Capital Stock*
1. Mr. Growmore's investment	$200,000	$ 50,000	$100,000	$50,000			
2. Donation of one-fourth of Mr. Growmore's shares ...	(50,000)						$(50,000)
3. Additional land and buildings	153,000	54,000	99,000				
4. Option—expired	500				$500		
5. Option—not expired or exercised	1,000					$1,000	
	$304,500	$104,000	$199,000	$50,000	$500	$1,000	$(50,000)

GAIN ON SALE OF LAND

Proceeds from sale of land	$40,000
Less cost:	
50,000 ÷ 20 = 2,500 × 8	20,000
Gain on sale of land	$20,000

(While the bookkeeper's contention that there was an involuntary conversion is correct, the books of account should be adjusted to conform to the known economic facts. The exercise of the ninety-day option may result in nonrecognition of the gain on sale of land for tax purposes and an adjusted tax basis for the new land acquired.)

FLOWERS, INC.

Working Trial Balance

December 31, 1959

Assets	*Per Books 12/31/59*	*Adjustments*		*Final Balance 12/31/59*
Current assets	$567,750			$567,750
Real estate	304,500		(1) $304,500	
Allowance for depreciation	(90,660)			(90,660)
Land		(1) $104,000	(2) 20,000	84,000
Buildings		(1) 199,000		199,000
Goodwill		(1) 50,000		50,000
Option to purchase land		(1) 1,000		1,000
	$781,590	$354,000	$324,500	$811,090
Liabilities and Stockholders' Equity				
Current liabilities	$137,000			$137,000
Estimated federal income tax			(6) $ 24,615	24,615
Suspense	80,000	(3) $ 37,000 (2) 40,000 (4) 3,000		
Capital stock	396,250	(5) 96,250	(1) 50,000	350,000
Retained earnings	168,340	(1) 500 (6) 24,615	(3) 37,000 (2) 20,000 (4) 3,000	203,225
Donated capital			(5) 96,250	96,250
	$781,590	$201,365	$230,865	$811,090

b.

ADJUSTING ENTRIES

(1)

Land	$104,000	
Buildings	199,000	
Goodwill	50,000	
Retained earnings (Miscellaneous expense)	500	
Option to purchase land	1,000	
Capital stock		$ 50,000
Real estate		304,500

To close real estate account and transfer balances therein to appropriate accounts

(2)

Suspense	40,000	
Land		20,000
Retained earnings (Gain on sale of land)		20,000
To reduce land account for cost of land sold and to take up gain on sale		

(3)

Suspense	37,000	
Retained earnings (Income from sale of flowers)		37,000
To take up proceeds from sale of flowers and nursery stock growing on land sold		

(4)

Suspense	3,000	
Retained earnings (Reimbursement for expenditures connected with moving fence)		3,000
To apply reimbursement for moving fence against expenses incurred in accomplishing the move		

(5)

Capital stock	96,250	
Donated capital		96,250
To transfer proceeds of sale of donated shares to donated capital and to adjust capital stock account to par value of 3,500 shares at $100 par (875 shares at $110 = $96,250)		

(6)

Retained earnings (federal income tax)	24,615	
Estimated federal income tax		24,615
To set up liability for 1959 federal income tax		

c.

FLOWERS, INC.
Balance Sheet—December 31, 1959

Assets

Current assets			$567,750
Fixed assets:			
Land		$ 84,000	
Buildings	$199,000		
Less accumulated depreciation	90,660	108,340	
Net fixed assets			192,340
Noncurrent assets:			
Goodwill		50,000	
Option to purchase land		1,000	
Total noncurrent assets			51,000
Total assets			$811,090

Liability and Stockholders' Equity

Current liabilities	$137,000	
Estimated federal income tax	24,615	
Total current liabilities		$161,615
Stockholders' equity:		
Capital stock—authorized and outstanding—3,500 shares at $100 par	350,000	
Donated capital	96,250	
Retained earnings	203,225	
Total stockholders' equity		649,475
Total liabilities and stockholders' equity		$811,090

If individual expense and income accounts were used when making adjustments the net credit balance of $34,885 should be closed to Retained Earnings.

Solution 5

THE HARDIN CORPORATION

Schedule Reflecting Computation of Amount Available for Deferred Incentive Compensation for 1959 Under the Deferred Incentive Compensation Plan

First limitation:		
Net income for the year ended December 31, 1959, after provision for federal taxes on income and provision for deferred incentive compensation		$ 393,504
Add provision for deferred compensation for 1959	$76,000	
Less tax benefit at 52%	39,520	36,480
Adjusted net income		$ 429,984
Average number of shares of common stock outstanding during the year:		
Shares outstanding from January through May—5 mo. @ 140,000 =		700,000
Shares outstanding from June through December—7 mo. @ 130,349 =		912,443
		1,612,443
Average—1,612,443 ÷ 12		134,370
Adjusted net income per share of common stock outstanding during 1959, based on 134,370 average monthly shares outstanding		$3.20
Deduct $1.50 per share		1.50
Excess of adjusted net income per share over $1.50		$1.70
Amount available for additional compensation for 1959 under this limitation		
a. $.40 on 1st dollar of excess income times 134,370 average shares		$ 53,748
b. $.30 on proportionate share ($.70) of 2nd dollar of excess income times 134,370 average shares		28,218
		$ 81,966
Second limitation:		
Amount available for additional compensation for 1959 limited to 18% of net income as adjusted above (18% × $429,984)		$ 77,397

Solution 6

BOND FUND

(1)

1958			
11/30	Bonds authorized—unissued	$90,000	
	Appropriations		$90,000
	To record authorization to issue bonds		

(2A)

Date	Account	Debit	Credit
1959			
2/1	Cash	93,636	
	Bonds authorized—unissued		90,000
	Premium on bonds		3,411
	Accrued interest on bonds		225
	To record sale of bonds		

(2B)

Date	Account	Debit	Credit
	Premium on bonds	3,411	
	Accrued interest on bonds	225	
	Cash		3,636
	To transfer premium and interest to general fund		

(3)

Date	Account	Debit	Credit
2/10	Expenditures	2,000	
	Cash		2,000
	To record payment to architect		

(4)

Date	Account	Debit	Credit
4/15	Expenditures	30,000	
	Retained percentages		3,000
	Cash		27,000
	To record initial payment to general contractor		

(6)

Date	Account	Debit	Credit
9/20	Expenditures	56,500	
	Cash		51,050
	Retained percentages		5,450
	To record payment to general contractor and architect		

(7A)

Date	Account	Debit	Credit
12/21	Retained percentages	8,450	
	Expenditures	1,070	
	Cash		9,520
	To record final payments to contractor and architect as follows:		

Total amount of contract including extras	$84,500
Architect's fee @ 6%	$ 5,070
Less amounts paid	4,000
	$ 1,070

(7B)

Date	Account	Debit	Credit
12/21	Appropriations	90,000	
	Expenditures		89,570
	Unappropriated surplus		430
	To close appropriation and expenditure accounts		

(7C)

Date	Account	Debit	Credit
12/21	Unappropriated surplus	430	
	Cash		430
	To close cash account and transfer to general fund		

GENERAL BONDED DEBT AND INTEREST ACCOUNTS

1959

(2)

2/1	Amount to be provided for payment of principal	$90,000	
	Amount to be provided for payment of interest	16,200	
	Bonds payable		$90,000
	Interest payable in future years		16,200
	To record sale of bonds and liability of future years for bond and interest payments		

1/1/59 to 1/1/60 90M @ 3% —	$ 2,700
1/1/60 to 1/1/61 90M @ 3% —	2,700
1/1/61 to 1/1/62 80M @ 3% —	2,400
1/1/62 to 1/1/63 70M @ 3% —	2,100
1/1/63 to 1/1/64 60M @ 3% —	1,800
1/1/64 to 1/1/65 50M @ 3% —	1,500
1/1/65 to 1/1/66 40M @ 3% —	1,200
1/1/66 to 1/1/67 30M @ 3% —	900
1/1/67 to 1/1/68 20M @ 3% —	600
1/1/68 to 1/1/69 10M @ 3% —	300
	$16,200

(5D)

9/1	Bonds payable	10,000	
	Interest payable	5,400	
	Amount to be provided for payment of principal		10,000
	Amount to be provided for payment of interest		5,400
	To reduce liability for bond principal and interest recorded in general fund		

GENERAL FIXED ASSET ACCOUNTS

(7E)

1959

12/21	Buildings	89,570	
	Investment in fixed assets from general obligation bonds		89,570
	To record cost of municipal building financed through issue of general obligation bonds		

GENERAL FUND

(2C)

1959			
2/1	Cash	$ 3,636	
	Premium on bonds		$ 3,411
	Accrued interest on bonds		225
	To record premium and accrued interest received on bonds		

(5A)

9/1	Estimated revenues	15,400	
	Appropriations		15,400
	To record adoption of ordinance for retirement of bonds and payment of interest on January 1, 1961		

(5B)

9/1	Taxes receivable—current	15,862	
	Estimated uncollectible current taxes		462
	Revenues		15,400
	To record levy of taxes		

(5C)

9/1	Expenditures	15,400	
	Matured bonds payable—due 1/1/61		10,000
	Accrued interest payable		5,400
	To record liability for interest and bonds		

(7D)

12/21	Cash	430	
	Unappropriated surplus		430
	To record receipt of cash from Bond Fund		

An alternative solution would be to provide for encumbering Bond Fund expenditures.

ACCOUNTING PRACTICE—PART II

May 19, 1960; 1:30 p.m. to 6:00 p.m.

Solution 1

JOURNAL ENTRY

(1)

a.

Depreciation	$ 375.00	
Allowance for depreciation—building		$ 375.00

(2)

Sale of property	20,966.02	
Allowance for depreciation—building	2,625.00	
Mortgage receivable	12,000.00	
Accrued taxes	521.28	
Land		2,000.00
Building		30,000.00
Prepaid insurance		22.50
Gain on sale of property		4,089.80

b.

Selling price			$34,000.00
Cost of property		$32,000.00	
Less: Depreciation to December 31, 1958	$ 2,250.00		
Depreciation 6 months 1959	375.00	2,625.00	
		29,375.00	
Expense of sale:			
Commission	500.00		
Revenue stamps	35.20	535.20	29,910.20
Gain on sale of property			$ 4,089.80

Solution 2

TRINITY CONSTRUCTION COMPANY

Worksheet on Conversion to Completed Contract Basis
December 31, 1959

	Trial Balance 12/31/59		Adjustments		Adjusted Trial Balance 12/31/59	
	Debit	Credit	Debit	Credit	Debit	Credit
Cash	$ 69,874.50				$ 69,874.50	
Accounts receivable—contracts			(3) $ 54,000.00		54,000.00	
Retained percentages receivable			(3) 22,000.00		22,000.00	
Costs of uncompleted contract in excess of related billings			(5) 6,500.00		6,500.00	
Accounts receivable—Partner A			(1) 600.00		600.00	
Equipment	30,000.00				30,000.00	
Accumulated depreciation—equipment				(4) $ 6,000.00		$ 6,000.00
Accounts payable				(2) 15,000.00		15,000.00
Accrued payroll taxes payable		$ 74.50		(6) 77.50 (7) 300.00		452.00
Accrued withholding taxes payable		800.00				800.00
Billings on uncompleted contracts in excess of related costs				(5) 51,080.00		51,080.00
A, Capital		30,000.00				30,000.00
B, Capital		32,000.00				32,000.00
Construction income		940,000.00	(5) 561,000.00	(3) 76,000.00		455,000.00
Construction costs	885,600.00		(2) 15,000.00 (4) 6,000.00	(1) 600.00 (5) 516,420.00	389,580.00	
Overhead expenses	17,400.00		(6) 77.50 (7) 300.00		17,777.50	
	$1,002,874.50	$1,002,874.50	$665,477.50	$665,477.50	$590,332.00	$590,332.00

Explanation of adjustments:

(1) To adjust for materials charged in Job No. 6 used in the addition to partner A's home.

(2) To record unpaid invoices and adjust total construction costs per books to total of detail on actual costs incurred, $900,600—$885,600.

(3) To record billed receivables as per Schedule I.

(4) To record depreciation on equipment for the year, 20% of $30,000.

(5) To adjust profit and loss accounts for income and costs on uncompleted jobs as per Schedule II.

(6) To adjust for employer's portion of F.I.C.A. taxes for the 4th quarter as per Schedule III.

(7) To adjust unemployment taxes payable on 4th quarter wages, $10,000 at 3 per cent.

SCHEDULE I

Trinity Construction Company

Computation of Accounts and Percentages Receivable—Contracts

December 31, 1959

Job No.	*Amount Billed During Year*	*Cash Received On Contracts*	*Accounts Receivable Contracts*	*Percentages Receivable Contracts*
1	$ 200,000	$200,000	$ —0—	$ —0—
2	210,000	195,000	15,000	—0—
3	160,000	160,000	—0—	—0—
4	220,000	180,000	18,000	22,000
5	81,000	75,000	6,000	—0—
6	50,000	40,000	10,000	—0—
7	95,000	90,000	5,000	—0—
	$1,016,000	$940,000	$54,000	$22,000

SCHEDULE II

Trinity Construction Company

Computation of Accumulated Costs Over or Under Related Billings on Uncompleted Contracts

December 31, 1959

Job No.	*Accumulated Costs Before Depreciation*	*Deprecia-tion*	*Total Accumulated Costs*	*Related Billings*	*Costs In Excess*	*Billings In Excess*
1	$171,000	$1,140	$172,140	$ 200,000	Completed	
2	180,000	1,200	181,200	210,000		$28,800
3	135,000	900	135,900	160,000	Completed	
4	225,000	1,500	226,500	220,000	$6,500	
5	63,000	420	63,420	81,000		17,580
6	45,000*	300	45,300	50,000		4,700
7	81,000	540	81,540	95,000	Completed	
	$900,000	$6,000†	$906,000	$1,016,000	$6,500	$51,080

*Costs after adjusting for $600 of materials used for additions to partner A's home.
†Prorated on basis of accumulated costs before depreciation.

SCHEDULE III

Trinity Construction Company

Computation of F.I.C.A. Adjustment for the Fourth Quarter

Income tax deducted, as given in problem		$2,500.00
Accrued withholding tax (per trial balance)		—800.00
Income tax remitted to depository		1,700.00
Total remitted to depository (given in problem)		2,048.00
F.I.C.A. tax remitted		$ 348.00
Divide by 2—employer's and employees' shares remitted		$ 174.00
Employees' share of tax $10,000 × 2.5%		$ 250.00
F.I.C.A. withheld, as given in problem		248.50
Under-withheld—adjust to expense		1.50
Employer's share of tax $10,000 × 2.5%	$250.00	
Portion remitted (see calculation above)	174.00	
Balance of employer's share		76.00
Total expense adjustment		$ 77.50

Solution 3

a. Income per preclosing trial balance	$590,000
Portion of goodwill allocated to spleen pill business—goodwill has no basis for tax purposes	130,000
Deferred portion of gain on sale of spleen pill business—installment basis (Schedule 1)	(400,000)
Reversing the opening inventory entry	(70,000)
Recording the value of the closing inventory	100,000
Depreciation of building (Schedule 2)	(9,000)
Depreciation of equipment (Schedule 3)	(17,833)
Research and experimental expenditures (Schedule 4)	(104,000)
Amortization of patents (Schedule 5)	(8,000)
Organization expenses deferred (Schedule 6)	45,000
Taxable income for year	$256,167

b. Tax computation (alternative method)	
Taxable income for year	$256,167
Less capital gain (re sale of spleen pill business)	100,000
	$156,167
Partial tax (52% of $156,167, less $5,500)	$ 75,707
25% of $100,000	25,000
Total tax	$100,707

Schedule 1—Installment sale of spleen pill business

Selling price	$500,000
Cost	—
Gain on sale	$500,000
Portion of selling price received during the year (not in excess of 30% of selling price)	$100,000
Gain recognized (100% of $100,000)	$100,000
Gain deferred ($500,000—$100,000)	$400,000

Schedule 2—Depreciation of Building

Cost of building January 1, 1959		$300,000
Life of building from January 1, 1959	25 years	
Depreciation (150% declining balance method; 4% × $300,000) for 6 months		$ 9,000

Schedule 3—Depreciation of Equipment

Item	*Months owned in taxable year*	*Rate*	*Basis*	*Depreciation*
Equipment from proprietorship	10	25% (A)	$60,000	$12,500
New pill crusher	6	20% (C)	10,000	1,000
No. 803 Deluxe press (used)	—	20% (B)	10,000	2,000
	4	25% (A)	28,000	2,333
Total				$17,833

(A) 150% declining-balance method (used equipment).
(B) Additional first year depreciation of 20%, which decreases the depreciation base.
(C) Double declining-balance method (new equipment).

Schedule 4—Research and Experimental Expenditures

Election, under Section 174, to charge research and experimental expenditures to costs and expenses as incurred:

Patent No. 269487	$ 40,800
Project No. 1	36,000
Project No. 2	27,200
	$104,000

Schedule 5—Amortization of Patents

Patent No. 145876:		
Cost November 1, 1958	$66,000	
Months to amortize (11/1/58—5/1/64)	66	
Amortization from 11/1/58 to 6/30/59 ($66,000 ÷ 66) × 8		$ 8,000

Schedule 6—Amortization of Organization Expenses

Total organization expenses	$54,000
Amortization for period 9/1/58—6/30/59 10/60 × $54,000	9,000
Organization expenses deferred	$45,000

Solution 4

a.

VANGUARD CORPORATION
Balance Sheet
December 31, 1959

Assets

Current assets		
Cash		$ 3,566,040
Accounts receivable	$ 3,350,000	
Less allowance for doubtful accounts	100,500	3,249,500
Inventories—at the lower of cost (first-in, first-out) or estimated realizable market		2,750,000
Total current assets		9,565,540
Fixed assets—at cost	4,000,000	
Less accumulated depreciation	1,774,500	
Total fixed assets		2,225,500
Total assets		$11,791,040

Liabilities and Stockholders' Equity

Current liabilities		
Notes payable due within one year		$ 1,000,000
Accounts payable and accrued liabilities		2,221,000
Provision for federal taxes on income		440,100
Total current liabilities		3,661,100
Notes payable due after one year		3,000,000
Stockholders' equity		
Capital stock—authorized 2,000,000 shares of $1 par value; issued and outstanding 1,050,000 shares	$ 1,050,000	
Additional paid-in capital	1,800,000	
Retained earnings	2,279,940	
Total stockholders' equity		5,129,940
Total liabilities and stockholders' equity		$11,791,040

b.

VANGUARD CORPORATION
Statement of Earnings
Year Ended December 31, 1959

Net sales		$15,650,000
Cost of sales		
Inventory at beginning of year	$ 2,800,000	
Purchases and freight-in during year	10,905,000	
	13,705,000	
Inventory at end of year	2,750,000	10,955,000
Gross profit		4,695,000
Operating and other expenses		
Interest	231,250	
Depreciation and amortization	474,500	
Provision for doubtful accounts	56,000	
Other administrative, selling and general expenses	2,403,250	3,165,000
Net earnings before provision for federal taxes on income		1,530,000
Provision for federal taxes on income		790,100
Net earnings for year		$ 739,900

c. **Statement of Retained Earnings Year Ended December 31, 1959**

Retained earnings at beginning of year		$ 2,300,040
Net earnings for year		739,900
		3,039,940
Less		
Cash dividends paid during year	$ 410,000	
Fair value of 50,000 shares of common stock issued as stock dividend	350,000	
		760,000
Retained earnings at end of year		$ 2,279,940

DETAIL OF SOLUTION

Balance Sheet

Cash		
Balance at December 31, 1958		$ 4,386,040
Add		
1959 net sales	$15,650,000	
Less December 31, 1959 accounts receivable	3,350,000	12,300,000
Accounts receivable at December 31, 1958	3,150,000	
Less accounts charged off in 1959	50,000	3,100,000
		19,786,040
Less		
Purchases and freight-in	10,905,000	
Other administrative, selling and general expenses	2,403,250	
	13,308,250	
Less December 31, 1959 accounts payable and accrued liabilities	2,221,000	
	11,087,250	
December 31, 1958 current liabilities	3,441,500	
Interest expense	231,250	
Fixed assets purchased in 1959	700,000	
Dividends paid	410,000	
Installment of 1959 tax paid prior to December 31, 1959	350,000	16,220,000
Balance at December 31, 1959		$ 3,566,040
Accounts receivable (information given)		$ 3,350,000
Allowance for doubtful accounts (3% of $3,350,000)		$ 100,500
Inventories (obtained from cost of sales section of Statement of Earnings)		$ 2,750,000
Fixed assets		
Depreciation expense in 1959 (per information given)	$ 474,500	
Depreciation on December 31, 1958 fixed assets (13% of $3,300,000)	429,000	
Depreciation on fixed asset additions in 1959	$ 45,500	
Per information given, one-half year's depreciation taken in year fixed assets acquired. Full year's depreciation	$ 91,000	
Depreciation rate 13%—1959 fixed asset additions		700,000
December 31, 1958 fixed assets		3,300,000
December 31, 1959 fixed assets		$ 4,000,000

Accumulated depreciation	
Balance December 31, 1958	$ 1,300,000
Depreciation expense in 1959 (information given)	474,500
Balance December 31, 1959	$ 1,774,500
Notes payable	
Due in twenty equal quarterly installments ($5,000,000 ÷ 20 = $250,000). Four installments of $250,000 each due in 1960	$ 1,000,000
Accounts payable and accrued liabilities (information given)	$ 2,221,000
Provision for federal taxes on income	
Provision for taxes on 1959 earnings per Statement of Earnings	$ 790,100
Less statutory exemption	100,000
	690,100
50% due on installments prior to December 31, 1959	350,000
	340,100
Add back statutory exemption	100,000
Balance December 31, 1959	$ 440,100
Notes payable due after one year	
Balance December 31, 1958	$ 4,000,000
Amount due within one year at December 31, 1959	1,000,000
Balance December 31, 1959	$ 3,000,000
Capital stock	
Balance at December 31, 1958	$ 1,000,000
Stock dividend of 5%	50,000
Balance at December 31, 1959	$ 1,050,000
Additional paid-in capital [50,000 sh. × $7 = $350,000 — (50,000 sh. × $1) = $300,000 increase]	$ 1,800,000
Retained earnings (per Statement of Retained Earnings)	$ 2,279,940

DETAILS OF SOLUTION
Statement of Earnings

Net sales (information given)				$15,650,000
Cost of sales				
Inventory at beginning of year (information given)			$ 2,800,000	
Purchases and freight-in during year (information given)			10,905,000	
			13,705,000	
Inventory at end of year (figure necessary for 30% gross profit)			2,750,000	10,955,000
Gross profit (30% of $15,650,000 per information given)				4,695,000
Operating and other expenses				
Interest (5% per annum on notes adjusted for 1959 quarterly payments of $250,000)			231,250	
Depreciation (information given)			474,500	
Provision for doubtful accounts			56,000	
Balance December 31, 1959 (3% of $3,350,000 per information given)	$100,500			
Balance December 31, 1958 (information given)	94,500			
Accounts charged off (information given)	50,000	44,500		
Amount required		$ 56,000		
Other administrative, selling and general expenses (information given)			2,403,250	3,165,000
Net earnings before provision for federal taxes on income				1,530,000
Provision for federal taxes on income (52% of $1,530,000 less $5,500)				790,100
Net earnings for year				$ 739,900

Statement of Retained Earnings

Retained earnings at beginning of year (information given)		$ 2,300,040
Net earnings for year (from Statement of Earnings)		739,900
		$ 3,039,940
Less		
Cash dividends paid during year (see computation)	$ 410,000	
Fair value of common stock issued as stock dividend (50,000 shares × $7)	350,000	
		760,000
Retained earnings at end of year		$ 2,279,940

Computation of cash dividends paid

1st quarter	1,000,000 shares @ .10 cents	100,000
2nd quarter	1,000,000 shares @ .10 cents	100,000
3rd quarter	1,050,000 shares @ .10 cents	105,000
4th quarter	1,050,000 shares @ .10 cents	105,000
Total cash dividends paid		$ 410,000

Solution 5

(1) Computation of write-down of the four parts:

Part Number	*May 31, 1959 Inventory Amount*	*Latest Net Selling Price of Part*	*Selling Price Less 15% for Selling Expense (Net Realizable Value)*	*Per Cent that May 31, 1959 Inventory Amount of Part Is Over NRV*	*Amount that Inventory Is Over NRV*
113250	$26,550	$23,426.46	$19,912.50	25%	$ 6,637.50
113475	6,360				1,590.00
113625	21,750				5,437.50
113830	5,435				1,358.75
					$ 15,023.75

(2) Computation of over-all write-down percentage:

Write-downs on four items above	$ 15,023.75
Write-downs on balance of test	46,938.55
Total write-down of test	$ 61,962.30
Inventory value of samples tested	$344,235
Per cent of write-down to inventory value	18%

(3) Computation of write-down:

Total May 31, 1959 inventory		$860,500	
Less—One drawworks		(55,000)	
One slush pump		(40,000)	
Inventory applicable to 18% write-down		$765,500	
18% × $765,500			$137,790
Add—Write-down on slush pump—			
Inventory price		$ 40,000	
Net selling price ($38,000 less 25%)	$28,500		
Less 15% for selling expenses	4,275	24,225	
Total write-down			15,775
			$153,565

Solution 6

a.

	Original Budget for 10,000 Units	Revised
Material A	$100,000	$ 80,500(1)
Material B	50,000	50,000
Material C	20,000	20,000
Direct labor—Cutting	80,000	84,000(2)
Direct labor—Shaping	40,000	42,000(2)
Direct labor—Assembling	20,000	21,000(2)
Direct labor—Boxing	10,000	10,500(2)
Manufacturing burden (50% of Direct labor)	75,000(40%)	63,000(3)
Totals	$395,000	$371,000

(1) Original standard	$100,000
Less material price variance	19,500
Revised	$ 80,500

Note: The material usage variance is a period cost and does not affect the revised standard.

(2)

	Cutting	Shaping	Assembling	Boxing
Original standard	$80,000	$40,000	$20,000	$10,000
Add 5% wage increase to direct workers	4,000	2,000	1,000	500
Revised	$84,000	$42,000	$21,000	$10,500

Note: The labor productivity variance, due to a shut-down caused by strike, is a period cost and does not affect the revised standard.

(3) Original standard	$ 75,000
Less permanent savings in costs of certain services	12,000
Revised	63,000
Total revised direct labor costs	$157,500
% of direct labor	40%

Note: The fixed overhead variance is a period cost and is fully absorbed by operations.

Revised Standard Cost

	Prime	Burden 40%	Total
Material A	$ 8.05		$ 8.05
Material B	5.00		5.00
Material C	2.00		2.00
Direct labor—cutting	8.40	$3.36	11.76
			26.81
Direct labor—shaping	4.20	1.68	5.88
			32.69
Direct labor—assembling	2.10	.84	2.94
			35.63
Direct labor—boxing	1.05	.42	1.47
Totals	$30.80	$6.30	$37.10

Revised Inventory

b.

100 units Material A		$ 805
100 units Material B		500
100 units Material C		200
200 Product X—cut	@ $26.81	5,362
200 Product X—shaped	32.69	6,538
200 Product X—assembled	35.63	7,126
200 Product X—boxed	37.10	7,420
Total		$27,951

AUDITING

May 19, 1960; 8:30 a.m. to 12:00 m.

Solution 1

The adequacy of internal control is the criterion upon the basis of which the accountant determines the kind and the extent of testing. Primarily the accountant is concerned with the trustworthiness of the data in the accounts. He therefore is interested in their quality, i.e., the extent to which they are free from errors in statistical classification as to kind and time as well as free from errors in application of generally accepted accounting principles.

Necessary tests are determined by a review of the internal control system and a careful examination of internal control procedures in actual operation.

If internal control procedures are inadequate or nonexistent, as may be the case in small business enterprises, then detailed analysis of ledger accounts, vouching of invoices for classification and distribution, vouching of checks, tracing of bank deposits, reconciliation of bank accounts, etc., may be required. The auditor considers the materiality of the respective transactions as well as errors, inconsistencies or unusual entries discovered during the audit in determining any extension of his tests.

The extent to which testing must be done is the result of the accountant's judgment based upon his experience. Keeping ever in mind that the balance sheet and related statements of income and retained earnings must not be misleading, he will do that amount of testing which will insure such results. This does not mean that the resulting statements will be in some sense "perfect" but will "fairly" present the financial position of an enterprise. Consequently the extent of testing is determined by the accountant's judgment of the quality of the accounting records as a basis for fair presentation of the financial aspects of the enterprise.

Solution 2

a. Yes. Footnote disclosure will explain the absence of income tax provision on the income statement and income tax liability on the balance sheet, which affects working capital ratios and comparisons with prior years. Adequate disclosure will prevent misunderstandings by third parties. The possibility of either voluntary or involuntary termination of the election may in some cases constitute a contingency which should be covered by footnote.

b. Taxable income per share or taxable income for each stockholder should be given to each stockholder at the end of the year. Taxable income per share may be different from "earnings per share" due to such factors as tax-exempt income, nondeductible expense, percentage depletion, the use of accelerated depreciation for tax purposes only, etc. The amount of taxable income may have to be broken down between net capital gains and the balance of taxable income. The source of dividends paid should be identified as current income and retained earnings, or earnings accumulated prior to the election to be taxed as a small business corporation.

If there is a net operating loss, each stockholder's share should be calculated and reported to him.

c. An unqualified audit report can be made. No exceptions as to consistency need be taken. Conditions have changed, but there is no change in the application of accounting principles. The important thing is to make sure that there has been adequate disclosure of the election and of its effects. An explanatory note may be inserted between the scope and opinion paragraphs of the auditor's certificate.

Solution 3

a. The purpose of this review is to ascertain whether there have been any material transactions or events which have a significant bearing on the certified statements and might require qualification of the auditor's opinion, disclosure by footnotes, or financial statement adjustments.

The post-audit review period ordinarily ends when field work is completed, February 20. The auditor, however, is responsible for disclosure of any material event of which he is aware until the delivery of his report, March 12. His report should be dated February 20, the date of completion of field work.

b. In preparing his program, the auditor considers the post-audit review as a continuation of the regular audit and, as in a continuing audit engagement, all audit steps may not be necessary. The suggested post-audit review program follows:

(1) Review all books of original entry for unusual transactions to the date of the close of field work, taking care to see that an accounting has been made for the serial numbers of all vouchers and for all check numbers.

(2) Review the January 31 financial statements prepared by the company as follows:

- (a) Test check the balance sheet, income and retained earnings statements to the general ledger accounts to ascertain that the amounts therein are in agreement with the books.
- (b) Compare the balance sheet with the audited balance sheet amounts and investigate important variations.
- (c) Compare the results of operations for the month of January with the January operations in the audited period and investigate any unusual or important variations.

(3) Discuss the following matters with company officials:
   (a) Sales and profit trends and significant sales trends in the industry
   (b) Company operations and market conditions.
   (c) Increases or decreases in the prices of the company's product.
   (d) Increases in basic raw material prices—which may result in decreasing gross profits.
   (e) Decreases in basic raw material prices—which may indicate inventory losses.
   (f) Major purchase commitments for material or capital additions.
   (g) Subsequent bookings or cancellations of sales orders.
   (h) Federal taxes—changes in law, revenue agents' reports, bureau engineer investigation, deficiency assessments, etc.
   (i) Renegotiation proceedings.
   (j) Wage and salary adjustments.
   (k) Pending lawsuits and settlement of same.
   (l) Special dividends.
   (m) Losses of important customers, exceptional bad debt losses, or pledging of receivables.
   (n) Changes in accounting and financial policies.
   (o) New borrowings, issue of stock or other financing, including any new dividend restrictions or important covenants agreed to in connection therewith.
   (p) Purchase or sale of major plant and equipment, fires, explosions, abandonments of plant, etc.
   (q) Strikes and status of wage negotiations in progress.
(4) Review corporate minutes of directors and stockholders to the close of field work.
(5) Obtain letters from company's legal counsel with respect to developments of any contingent liabilities, together with an opinion as to the outcome of any pending litigation.
(6) Secure a representation letter from responsible company officers that there have been no material events or transactions subsequent to the audit date which might have a material effect on the audited financial statements. Generally speaking, this letter would place in written form the company's replies or representations received for the statements in (3).

Solution 4

a. To select a comprehensive sample representative of the whole payroll, the auditor considers the following factors:
(1) Quality of internal control.
(2) Number of departments (consider departmental wage rates).
(3) Frequency of payrolls.
(4) Types, functions and job classifications.
(5) Random selection within a department.
(6) Block selection within a department.
(7) Total number of employees.

b.

Column #	*Means of verification*
1, 2 & 3	Employment record maintained in personnel department.
4 & 5	Clock cards, time tickets, or timekeeper's report.
6	Union contract or personnel department.
7	(1) Reference to union contract for premium time provision. (2) Extension of Column 6 $\times$ (Column 4 + Column 5).
8	(1) Reference to employee earnings record to determine whether employee is subject to tax. (2) Extension of current rate $\times$ taxable portion of current earnings.
9	(1) Reference to employee signed W-4 card for number of exemptions claimed. (2) Reference to an income tax withheld table.
10 & 11	Employee signed withholding authorization.
12	Column 7 less Columns 8, 9, 10 and 11.
13	(1) Examine check for alterations. (2) Compare name on payroll and payee. (3) Compare amounts paid. (4) Examine endorsements paying particular attention to unusual second endorsements. (5) Compare signature on endorsement with signature on W-4 statement looking for obvious differences. (6) Review check numbers for sequence.
14 & 15	(1) Trace gross amount of earnings to account posting in the general ledger on a sample basis. (2) From the job description indicated determine the reasonableness of the account charged. (An example of unreasonableness would be: Job classification—Sweeper; Account charged—Machine maintenance.)

c. Additional audit procedures:

(1) Test payroll record footings and postings.
(2) Reconcile the total payroll with federal tax data.
(3) Verify unclaimed wages.
(4) Verify accrued wages and salaries.
(5) Observe or perform a distribution of the payroll.
(6) Payroll tests on salaried payroll and/or officers salaries.
(7) Verify liability for employee withholding (federal income tax, employer portion of F.I.C.A., union dues withheld, etc.)
(8) Verify reconciliation of payroll bank accounts.
(9) Reconcile labor distribution cost records and payroll.

Solution 5

NEVER-SLIP CORPORATION

a.

Accounts Receivable

	Per Books	12/31/59 Adjustments Dr.	Cr.	Final
Accounts receivable—(A-1)	$184,092.42	(3) $384.00	(1) $ 10.00	
		(4) 16.54	(5) 416.52	
			(6) 18.22	$184,048.22
	$184,092.42	$400.54	$444.74	$184,048.22
Allowance for bad debts—(A-2)	$ 3,886.44	(1) $ 10.00	(2) $ 85.00	
		(5) 416.52		
		(7) 1,291.34		$ 2,253.58
	$ 3,886.44	$1,717.86	$ 85.00	$ 2,253.58

	Corrected Balances	Bad	Doubtful	Remainder	Percentage for Allowance
Current—under 1 month	$ 92,715.60			$ 92,715.60	½%
Past due:					
1-3 months	57,998.15			57,998.15	1%
3-6 months	29,126.89			29,126.89	2%
Over 6 months	4,624.10	$416.52	$516.80	3,690.78	10%
	$184,464.74	$416.52	$516.80	$183,531.42	
	(A-3)		50%		

ALLOWANCE FOR BAD DEBT REQUIREMENTS—SUMMARY

Accounts receivable:		
Under 1 month	½%	$ 463.58
1-3 months	1%	579.98
3-6 months	2%	582.54
Over 6 months:		
Good	10%	369.08
Doubtful	50%	258.40
	(A-2)	$2,253.58

BALANCE OF ALLOWANCE FOR BAD DEBTS

Balance per general ledger	$3,886.44	
Add:		
A.J.E. #2	85.00	$3,971.44
Less:		
A.J.E. #1	10.00	
A.J.E. #6	416.52	426.52
		$3,544.92

ADJUSTMENT OF ALLOWANCE FOR BAD DEBTS

Balance of account	$3,544.92
Requirements	2,253.58
Adjustment—A.J.E. #8	$1,291.34

NEVER-SLIP CORPORATION

Accounts Receivable

		General Ledger Control		Subsidiary Ledger		Age of Debit Balances				
	A.J.E.	Debit	Credit	Debit Balances	Credit Balances	Under 1 Month	1-3 Months	3-6 Months	Over 6 Months	Total
Totals per subsidiary ledger schedule				$184,536.74	$472.54	$92,715.60	$58,070.15	$29,126.89	$4,624.10	$184,536.74
Balance per general ledger		$184,092.42								
To correct addition in G.J. as of 10/31/59	#1		$10.00							
To set up liability on sales contract	#3	384.00			(384.00)					
Britting Cafeteria — should be Britt Motor Co.				(72.00)	(72.00)		(72.00)			(72.00)
		184,476.42	$10.00	184,464.74	$ 16.54	$92,715.60	$57,998.15	$29,126.89	$4,624.10	$184,464.74
		10.00								
		184,466.42								(A-3)
Customers' credit balances	#4	16.54								
		184,482.96								
Bad accounts charged off	#5	416.52		416.52						
		184,066.44		$184,048.22						
Adjustment of control	#6	18.22								
		$184,048.22								
		(A-1)								

NEVER-SLIP CORPORATION

b.

Adjusting Journal Entries

December 31, 1959

	Debit	Credit
—1—		
Allowance for bad debts	$ 10.00	
Accounts receivable		$ 10.00
To correct addition in G.J. entry of 10/31/59		
—2—		
Bad debts	85.00	
Allowance for bad debts		85.00
Account of John Smith collected and credited to bad debts account in error		
—3—		
Accounts receivable	384.00	
Advance on sales contract		384.00
To set up liability on contract		
—4*—		
Accounts receivable	16.54	
Customers' credit balances		16.54
To set up as a liability		
—5—		
Allowance for bad debts	416.52	
Accounts receivable		416.52
Bad accounts charged off		
—6—		
Adjustment of accounts receivable	18.22	
Accounts receivable		18.22
To adjust control to subsidiary ledger		
—7—		
Allowance for bad debts	1,291.34	
Bad debts		1,291.34
To adjust to requirements		

*Working paper reclassification entry

Solution 6

a. February 10, 1960

Mr. Harold Henderson, Controller
Kent County Grain and Milling Company
135 East Seventh Street
New Orleans, Louisiana

Dear Mr. Henderson:

At your request, I have reviewed the accounting records and system of internal accounting control surrounding the purchase, issuance, and redemption of fifty-cent (50¢) flour coupons. Based upon my observation and upon information obtained from company personnel, I have the following comments and recommendations to make:

1. A receiving report is prepared of coupons received from the printer based upon packages obtained times the indicated amount included in each package. It is suggested that the quantities in packages be tested at random based upon some predetermined basis.

2. Unused coupons are presently stored in an unlocked storeroom and a line foreman obtains enough each day to meet the day's production. The unused coupons should be kept under lock and key and they should be given to the line foreman only upon presentation of a properly approved requisition.

3. Perpetual records of coupons received from the printer, coupons issued for production or damaged, and coupons on hand are now kept by the production superintendent. This record should be kept by the cost accounting department, as well as the record of those coupons included in flour sold, those coupons redeemed, and those coupons still outstanding.

4. A physical inventory of unused coupons on hand should be taken periodically and reconciled by the cost accounting department with its records. Damaged coupons should be reported to the cost accounting department on the daily production report and destroyed under its supervision.

5. The mail department should make a daily summary of coupons turned over to the cashier's department for redemption. Each week this information should be agreed with the coupons and amounts indicated as redeemed as shown on the cashier's weekly reimbursement request.

6. As the coupons are redeemed they should be sorted by city and state and reviewed to ascertain that no disproportionate share of the redemptions are coming from any one area.

7. Complaints from customers concerning coupon redemptions should be routed to someone not connected with handling or approving the disbursement of the cash. The cashier is presently handling complaints.

8. The cashier forwards the sealed envelope containing the fifty-cent piece to the mail department. A mail sack should be obtained for the cashier's department and the cashier should put the envelopes in this sack. The sack should be closed by the cashier and delivered to the post office directly rather than through the mail department.

9. An expiration date should be printed on the face of each coupon, based upon and subsequent to the completion date of the promotional campaign.

10. Coupons still on hand at the completion of the campaign should be destroyed under the supervision of the cost accounting department, after its final physical inventory and reconciliation.

I shall be happy to discuss any of these comments and suggestions in further detail if you so desire.

Yours very truly,

b.

Advertising and promotion	$3,125	
Liability for unredeemed flour coupons		$3,125
To set up liability for unredeemed flour coupons at December 31, 1959		

Computation of Liability

Coupons included in sacks per production records	75,000
Coupons included in production still in warehouse	25,000
Coupons in hands of retail outlets or consumers	50,000
Redeemed through December 31, 1959	37,500
Outstanding and unredeemed	12,500
Percentage of unredeemed estimated to be redeemed	50%
Estimated number to be redeemed	6,250
Value of each coupon	50¢
	$3,125

It was assumed that the difference between the 73,000 unused coupons indicated as being on hand as shown on the superintendent's records and the 71,250 coupons physically inventoried represented unreported damaged and destroyed coupons.

Solution 7

a. Inasmuch as this is an initial audit and a complete physical inventory will not be taken at one time, inventories present a threefold problem to the auditor as follows:

1. The reasonableness of quantities, clerical accuracy and valuation must be established for purposes of the September 30, 1959 balance sheet.
2. The reasonableness of the beginning inventories (September 30, 1958) must also be established to test the income statement.
3. Consistency of company policies in pricing inventories also must be determined. This involves ascertaining that inventories at the beginning of the preceding fiscal year, i.e., the September 30, 1957 inventories, were priced in a consistent manner with the policies applied in succeeding years. This must be done to ascertain that income measurement in 1958 and 1959 is consistent insofar as the inventories are concerned.

   In summary, quantities, pricing and clerical accuracy must be tested with respect to the September 30, 1959 and 1958 inventories. Certain tests of the September 30, 1957 inventories will also be required to establish consistency of pricing policies between years. Inasmuch as the auditor was engaged at midyear, he can observe the taking of interim physical inventories.

b. Physical quantities will be tested as follows:

1. Review company procedures to determine degree and reliability of control exercised, existence of production control, etc.
2. Observe inventory crews in action; test accuracy of their counts and related procedures.
3. Make appropriate test counts to establish reliability of quantities as shown by perpetual records.
4. Review inventory variations requiring adjustment as developed by cycle counts.
5. Test entries in perpetual records by reference to underlying documents. Reconcile selected items to beginning and ending inventory quantity balances.
6. Review and test adequacy of inventory cutoff procedures at time of (1) cycle counts and (2) at year-end for summarization purposes.
7. Make over-all inventory reconciliation of beginning and ending inventories. Test gross profit ratios. Investigate unusual variations.
8. Test beginning and ending inventory summaries to perpetual records. At year-end, investigate unusual quantity variations and test count any unusually significant additions noted.

c. Inventory obsolescence presents two problems: (1) determination of the degree or amount of obsolescence and (2) determination of when the obsolescence should have been or should be recognized in the accounts.

Degree of obsolescence should preferably be measured by qualified company personnel. It is clear that the present method of providing for obsolescence is inadequate because it gives no weight to the relationship of inventory quantities to production or sales requirements, to desirable inventory levels, to probable usage within a reasonable time, to ultimate realization on excess quantities or to other factors. Although the auditor's test indicates an obsolescence factor of approximately $50,000, a more accurate determination should be made by the company.

To the extent practicable, the development of the amount of obsolescence should be accomplished in a manner which will establish approximately when obsolescence should have been recognized. The subsequent recording of the reserve adjustment may then be split to charge current income with obsolescence considered to occur in 1959 and to charge retained earnings with the portion of the adjustment considered applicable to prior years.

The auditor should preferably assist the company in establishing a realistic policy for recognizing obsolescence.

It must also be recognized that the company may not fully agree with the auditor and refuse to adjust its accounts further. If this situation arises, the auditor must carefully evaluate company arguments. If they lack substance, he may be forced to qualify his certificate with respect to financial position and, if the amounts applicable to the current year are significant, also with respect to the income statement.

Solution 8

a. The full work program and permanent file should include the following auditing procedures:

1. Obtain excerpts of patents or a letter from the holder (patent attorney) describing the patents and acknowledging their existence and genuineness.
2. Make a schedule of each patent indicating:
   (a) Date granted
   (b) Description of each patent
   (c) Actual cost (balance in the accounts plus the additions or subtractions during the year with comments on the debits or credits and the validity thereof)
   (d) Degree of usage on each patent
3. Verify the development costs of the client's staff and prove the entries that have been made in the accounts.
4. Comment on the method of amortization. In this problem, the auditor must discuss the lack of amortization with the officers and decide on the proper method of adjustment.
5. Determine if any legal suits involving infringements are pending and try to ascertain the probable outcome.

b. The legal costs in defending the validity of the patent and those costs incurred in the successful outcome of the infringement suit are properly capitalized according to sound accounting logic, as indicated in the detailed patent account in the problem. *However,* the cost of litigation in successfully defending a patent case is required, in conforming to the income tax regulations, to be charged to expense in the tax year in which it is incurred. As an auditor, you should inform your client as to the income tax requirements, which also provide that damages received from such litigations are included in gross income. Correspondingly, costs of litigation are deductible as expenses.

The cost of improvements, unpatented, have not extended the legal life of the patent, and are in the form of "repairs" to reduce the possibility of supersession by a better device. There is no certainty that the improvement will affect the productive life of the patent, and if so, the improvements should be patented. Only expenditures necessary to protect the patent rights are elements of cost, which would include experimental, research, and development labor, materials, and overhead, government and attorney fees, models, etc. The company has *failed to amortize* any portion of the patent. The maximum legal life of patents is seventeen years, but, as in this case, the usefulness of the patents may cease prior to the expiration of that period. The shorter useful life period should be the period of amortization. Factors such as obsolescence, supersession, change in demand, and inadequacy should all be considered in determining the amount of amortization to be taken. The auditor should confer with the corporation officers concerning this matter. The amortization may be divided into charges to retained earnings for the portion applicable to prior years, and to current income for the current portion.

COMMERCIAL LAW

May 20, 1960; 8:30 a.m. to 12:00 m.

Solution 1

Item No.	*Answer*	*Item No.*	*Answer*
1	a	11	c
2	c	12	h
3	c	13	d
4	z	14	z
5	c	15	c
6	a	16	a
7	a	17	z
8	c	18	a
9	d	19	c
10	z	20	a

Solution 2

	a	*b*	*c*	*d*	*e*
1.					X
2.	X		X		
3.					X
4.					X
5.		X		X	
6.	X				
7.		X	X		
8.	X			X	
9.		X		X	
10.		X	X		
11.			X		
12.			X		
13.				X	
14.	X	X		X	
15.	X	X		X	
16.		X			
17.					X
18.				X	
19.	X	X		X	
20.			X		

Solution 3

	a	*b*	*c*	*d*	*e*
1.			X	X	
2.				X	
3.				X	
4.		X			
5.			X		
6.				X	
7.					X
8.					X
9.	X				
10.					X
11.		X			
12.				X	
13.		X	X		
14.				X	
15.	X	X	X	X	
16.			X	X	
17.	X			X	
18.	X	X	X		
19.				X	
20.		X	X		

Solution 4

	a	b	c	d	e
1.		X			
2.		X			
3.	X		X	X	
4.	X				
5.				X	
6.		X	X	X	
7.					X
8.				X	
9.	X	X	X	X	
10.	X	X	X	X	
11.			X	X	
12.					X
13.		X			
14.		X			
15.	X		X		
16.		X	X		
17.			X		
18.				X	
19.		X	X	X	
20.	X	X	X		

Solution 5

a. A broker is an independent contractor whose purpose is to bring the buyer and seller together, and he thus may represent either the buyer or seller. He usually confines his business to a particular product or a group of related products and represents a number of different buyers and sellers of the product. He has no power to bind his principal, carries no inventory, and generally obtains a commission for his compensation.

b. A commission merchant is an independent contractor who handles merchandise which is sent to him on consignment, selling in his own name for his principal. Although the principal owns the inventory in possession of the commission merchant, the commission merchant has a lien thereon for his compensation, which may be in the form of a commission or an overage based on the difference between the sales price and the amount at which the goods are billed to him on consignment.

c. A del credere agent is a commission agent who usually for a higher commission guarantees the accounts of his customers, although the principal will look to the buyer primarily for payment for the goods.

d. A distributor is an independent contractor who purchases merchandise outright, on his own account, depending for his compensation upon his ability to resell the goods at a profit. He differs from an ordinary customer in that he usually has an exclusive territory and a group of dealers which he assists in promoting the sale of the product. The MFG Co. would look directly to the distributor for payment for merchandise sold to him.

e. A manufacturer's agent may be an employee, although he usually operates his own business, representing several manufacturers with related lines of noncompeting merchandise. He seldom carries any inventory and is compensated by means of a commission, or in rare instances by an overage.

f. A salesman is an employee, compensated by a commission and/or salary. He carries no inventory, and may have power to bind his principal, depending upon the terms of the sales contract used.

Solution 6

a. The portion of the brochure "extolling the virtues of the product" is simply opinion or "puffing," but the "specifications and results of laboratory tests" are such promises or affirmations as to constitute express warranties. Of course X Co. must demonstrate that the material failed to meet the standards set forth in the brochure. It would have no claim if stresses to which the material was subjected by it in making raincoats exceeded those which Y Co. had expressly warranted.

The provisions pertaining to warranty in sale by description are related to the above question, but X Co. would recover only if it showed that the material differed from the data given in the brochure.

Provisions concerning implied warranties of quality would also be pertinent. Thus, X would recover if the goods were not of merchantable quality, as Y Co. is quite clearly a dealer or merchant in the goods, which were bought by description. But Y Co. would not be liable for the implied warranty of fitness if X Co. had ordered the material under a patent or trade name and acted thereon. However, X Co. would recover if there were a usage of the trade implying fitness for the particular use of the material.

b. In this situation, there would be no express warranties upon which X Co. could recover. However, if X could show that the bulk did not correspond with the sample, or that there were defects which would not be apparent on reasonable examination of the sample, X would have a valid claim against Y. The provisions pertaining to implied warranties with respect to patent or trade name and trade usage would also seem to be applicable here.

c. X Co. has a clearly valid claim since it relied solely upon the seller's skill and judgment, and the material is definitely unsuitable for the purpose for which the seller knew it was going to be used.

Solution 7

a. 1. The owner of the material will bear the loss in a situation of this kind. Since the particular material is to be returned to the person who transferred possession to another, this is a bailment for mutual benefit, not a sale of the material. Consequently, ownership was retained by C, who must bear the burden of the loss because the damage was not due to negligence or lack of ordinary (reasonable) care by M.

2. This is also a bailment, but the bailee has diverted the property to a use not contemplated by the bailment contract. Consequently, M must bear the burden of any damages sustained to the bailed property when it is so diverted, regardless of his lack of negligence as to the fire. There is an exception to this general rule in the case of fungible goods, but broadcloth, even though easily replaceable, would not be considered to be fungible goods.

b. 1. This is a bailment for the mutual benefit of the bailor and the bailee. Leaving the door to the truck unlocked is a breach of the ordinary care required by a bailee in this type of bailment. Thus P would be liable for the loss incurred.
2. Locking the truck would be an adequate precautionary measure to take under the circumstances. Therefore the loss would fall upon the bailor.
3. The character of the property which is the subject of the bailment has a direct bearing upon the type of precautionary activity which must be followed by the bailee. Therefore, something more than a padlock would be expected as ordinary care if the property were expensive jewelry instead of relatively inexpensive specialty merchandise. A special set of locks, a special alarm system on the truck, or even the presence of a guard in the truck at all times could reasonably be required. P would bear the loss in this instance.

Solution 8

a. 1. Yes. The workmen's compensation acts are based on a concept of liability without fault. The employee need only demonstrate that the accident, and consequent injury, arose out of and in the course of his employment. The fact of his contributory negligence, or even his own gross negligence has no bearing upon the decision. He will clearly recover.
2. Yes. An employee is not entitled to recover if the injury occurs while he has digressed from his employment. However, deliberate disobedience of instructions has not always been held to be such a digression. In this case, the accident arose out of the employment, and occurred while the employee was attempting to further that employment. Therefore his disobedience did not involve the doing of a prohibited act but the doing of a necessary act in a prohibited manner.

b. The principal test in differentiating between an employee and an independent contractor is one of control. An independent contractor is not subject to control over the details of the work and the manner in which it is to be performed, but is responsible only for completion of the project in a satisfactory manner. In addition, he is usually engaged to accomplish a given task or complete a particular project, rather than to render service for a specified period of time. He operates his own independent business, performing similar tasks for numerous persons, not a single employer, and usually has his own tools and equipment. Although his compensation may on occasion take forms similar to those used for employees, he is usually compensated on the basis of the completed task or project.

c. 1. An employee is held not to be in the course of his employment while he is on his way to work. Thus this employee would not be able to recover.
2. It is usually held that employment for this purpose begins when the gate of the employer's property has been passed. Thus, in this case, he would recover.

THEORY OF ACCOUNTS

May 20, 1960; 1:30 p.m. to 5:00 p.m.

Solution 1

Part a	*Part b*	*Part c*
1. A	11. J	21. O
2. B	12. K	22. O
3. A	13. H	23. O
4. B	14. K	24. O
5. D	15. G	25. L
6. C	16. H	26. O
7. D	17. G	27. N
8. A	18. K	28. P
9. B	19. H	29. P
10. C	20. G	30. O

Solution 2

a. This situation is the same as any which involves inventory or product costs and the same principles of accounting apply. The governing principle is that of matching costs with related revenues. Specifically, it is appropriate to carry forward as an asset any cost outlay that will clearly result in future benefits. The cost outlay becomes a utilized cost in the period or periods in which it aids in producing revenues. The cost outlay becomes a lost cost when it expires without producing revenues.

b. The four accounts shown for Enter-tane, Inc. should be reported as follows:

1. Two-thirds of the cost of Sealing Wax and Kings should be charged against revenue for the period just ended. The balance should be carried forward to the next period. Thus the income statement should show $34,000 as part of Cost of Sales, and the balance sheet should show $17,000 as a part of the inventory of programs.
2. The $36,000 balance in The Messenger account should be treated as part of the Cost of Sales for the period just ended. No part of this should be deferred since re-run of the program is solely at the option of the sponsor and is a contingency, not a certainty.
3. The balance in The Desperado account should be capitalized and reported on the balance sheet as a current asset, analogous to inventory. The fact that it was carried to completion and is currently being considered for sponsorship by several companies indicates substantial probability of future benefit.
4. The balance in the Shin Bone account should be written off to current operations, as is appropriate for the cost of any unsalable product or inventory.

c. The first four items are product costs and the fifth item is an expenditure designed to provide benefits over a period of time. Both types of expenditures, to the extent that they will result in future benefits, should be capitalized and carried forward to future periods.

In a more limited sense, the form of the future benefit is different. The development of television programs presumably contributes to future income by increasing revenue, while studio rearrangement costs contribute to future income by reducing operating costs.

Also the television program expenditures become a part of inventory directly and are thus a current asset immediately. Studio rearrangement costs would be initially a deferred charge, noncurrent asset, and would be charged to operations over a reasonable period of time or the life of the lease whichever was the shorter period.

Solution 3

a. Joint products represent two or more products separated in the course of the same processing operation (derived from a common source of materials) each usually requiring further processing and each product having such relative value that no one product can be designated as a major product.

By-product is an article relatively minor in terms of value derived incidental to the production or manufacture of one or more major products.

b. Acceptable methods of accounting for the by-product in the determination of the cost of the major products are:

1. To allocate all producing costs to the major products, ignoring the recovery value of the by-product. The recovery value would be treated as "other income," included with major product sales, or as a deduction from cost of sales of the main product. This method would be acceptable only when there would be very little value in the by-product and the use of a more detailed method would entail accounting costs disproportionate to the benefits derived.
2. To treat either the proceeds from the sale of the by-product or the anticipated net yield of residuals (by-products) as a reduction in the total production costs of main products. This method reflects a lower valuation of major product inventories.
3. To assign to the by-product the replacement cost of the by-product. This method is peculiar to those industries which are able to use the by-product produced within the plant, thus eliminating the purchase of materials from outside vendors. Production costs of the main product are relieved by the amount of the replacement cost of the by-product.

c. Acceptable methods of allocating to joint products the cost of the initial producing department are:

1. To allocate joint costs on the basis of the relative selling prices of the end products. The argument is that if one product sells for more than another, it is because it costs more to produce.
2. To allocate joint costs on the basis of some unit of measurement, such as units, pounds, tons or gallons. If the joint products are not measurable,

they must be converted to a denominator that is common to all the units produced.

3. To allocate joint costs on the basis of a survey in which consideration is given to factors such as volume, selling price, technical engineering and marketing processes.

4. To allocate joint costs on the basis of the profit margin or "profit contribution" remaining after deduction of all direct costs and expenses from the selling price. This method is a variation of the market price method described above.

Solution 4

a. 1. Amortize the charge over the remainder of the original life of the bonds refunded. This method is defended on the grounds that the costs are those of making a more advantageous contract that will benefit future periods, specifically the periods representing the unexpired term of the bonds refunded. The cost of receiving this benefit should be spread over the period benefited.

Under this method the portion of the cost to be carried forward is the excess of the cost over the reduction in current income taxes.

2. Record a write-off against revenue, or against retained earnings. This treatment is defended on the grounds that the amount involved is the cost of terminating a disadvantageous contract. As such, it is a loss on a closed transaction and should be written off.

Ordinarily the write-off should be against revenue of the current period. However, if the amounts involved are so large in relation to net income as to impair the significance of the income figure, so that misleading inferences might result, the write-off should be against retained earnings. In this event the amount of write-off should be limited to the excess of the cost over the reduction of current income taxes due to the refunding.

3. Amortize the charge over a shorter period than the remainder of the original life of the bonds refunded, as long as the charge is made against income and is not in any year so large as seriously to distort the income figure for that year. Such acceleration may be regarded as a middle course between the two alternatives mentioned.

b. Under method 1 above, which is preferred accounting opinion, the following entry would be required:

6½% bonds payable	$500,000	
Loss on bond retirement	15,470	
Bond refunding costs	14,280	
Unamortized discount & issue expense		$ 17,250
Cash		512,500

The bond refunding costs would be amortized over the remaining 207 months of the life of the original issue.

Method 2, which is acceptable, but not preferred, would require the same entry except that the charge to bond refunding costs above would be made instead to retained earnings.

Solution 5

a. The term "contingency," as used in accounting, refers to a situation involving a considerable degree of uncertainty which may, through a related future event, give rise to the loss or acquisition of an asset or the incurrance or avoidance of a liability.

b. Prospective losses arising out of contingencies where the outcome is reasonably foreseeable should be reflected in the accounts, if material in their effect upon financial position or operation. However, prospective gains arising out of such contingencies, even though reasonably foreseeable, are not usually reflected in the accounts, since to do so might involve recording revenue prior to its realization.

Where the outcome of the contingency is not sufficiently predictable to permit recording in the accounts, the treatment of prospective gains dependent upon the contingency would be the same as the treatment of prospective losses. If material in amount, either a prospective gain or a prospective loss should be disclosed by footnote.

c. 1. There would be no need for disclosure in any form. Since the suit asks for nominal damages only, the amounts would not be material. Under other circumstances, this fact alone might not be controlling, since the principal effect of a successful patent infringement suit might be denial of the right to use the patented process or article, with consequent effects on operations of future periods. Here, however, the patent is 15 years old, only two years away from expiration, and such an effect seems unlikely.

2. No disclosure needs to be made. Such an event lies entirely in the future, and is too uncertain to warrant even footnote disclosure.

3. If this amount is material, approximately $40,000 after providing for an income tax refund, disclosure must be made. If, as it would appear here, an approximate amount is reasonably determinable then it should be recorded in the accounts. Failure to do so would be a clear violation of generally accepted accounting principles and would require that the accountant take an exception in his report.

4. This is not a contingency, within the meaning expressed in part (a) above. Therefore the presentation of financial statements, as affected by this situation, should be made in accordance with the accounting principles applicable to tax allocation situations. Specifically, if the amounts involved are material, there should be recognized in the accounts the amount of deferred income taxes due to the difference in depreciation methods for tax and book purposes.

Solution 6

1. Minority stockholders generally can obtain very little information such as detail of assets, liabilities, and income of the subsidiary. Also the volume of business done by the subsidiary with the parent or other affiliates is not disclosed. This is very important since the parent company generally controls the distribution of sales within the affiliated group and presumably could limit such sales.

2. Creditors are primarily concerned with the specific debtor company. While the combined assets of the group may be a measure of moral ability to pay, the consolidated assets are not legally available (unless specified by agreement) to meet creditor claims of a specific company in the group.

3. Liens on assets which affect the rights of creditors are often difficult to show or explain by footnotes. A pledge of subsidiary stock for parent company debt affects the subsidiary's assets. A consolidated balance sheet does not detail the assets affected nor will it show the subsidiaries' liabilities which rank ahead of any claims arising from the pledged stock.

4. A consolidated statement is a composite and therefore net current assets represent an average. Thus a weak position of one company may offset a strong position of another.

5. Where finished goods of one company become the raw materials of an affiliate through intercompany sales, a consolidated balance sheet may give an erroneous impression as to the liquidity of inventories.

6. The operating results of individual companies are not set forth in consolidated statements. The group may be able to carry a "weak sister," which might be in danger of being lost to preferred stockholders or creditors.

7. Ratio analysis is not reliable. Good and bad features are not disclosed and ratios may be affected by intercompany eliminations.

8. Consolidated statements are a poor basis for assessing possible dividend policy. Subsidiary profits do not belong to the parent until a dividend is declared by the subsidiary and there is no way to determine the individual company's ability to pay a dividend.

9. Improper conclusions may be drawn if a foreign subsidiary is consolidated, particularly if foreign cash is subject to fluctuating exchange rates or assets are subject to foreign government restrictions.

Solution 7

The company should record the unfunded past service liability for employees presently retired or eligible to retire at their own option. The company has no control over this liability short of terminating the plan. Also, the company cannot count on any further service from such employees and should have provided for their pensions prior to the dates the employees became eligible to retire. The liability related to these employees aggregates $1,241,000. If the company is reasonably assured of future tax benefit from payment of this amount into the pension trust, the liability should be recorded net of estimated future tax benefit, or approximately $595,000.

With regard to the employees under retirement age, the unfunded past service liability of $1,569,000 should have been recognized over a reasonable period of years, preferably related to the remaining service lives of the employees. Preferably a pro-rata portion of this liability of $1,569,000 should have been recorded during the period of the plan's existence to date. As a minimum, the practice should be established to recognize this liability over the remaining service lives of the covered employees.

Solution 8

The contracts receivable account (other than past due payments) and the contra unearned rental income account should be treated as memorandum accounts and should not be reflected on the balance sheet. To include these accounts in the balance sheet has the effect of ballooning the total assets and total liabilities and thus presenting a misleading impression of the size of the company.

The leased equipment is not a current asset, but the installment loans payable due within one year would normally be classified as current liabilities. This treatment would generally result in a working capital deficiency inasmuch as the funds to meet the maturing installment payments come from the lease rentals not reflected on the statements. However, the term "current liabilities" is normally used to designate obligations whose liquidation is reasonably expected to require the use of either existing resources properly classifiable as current assets or those which will come into existence as a result of normal operations. Therefore, it is preferable not to segregate as current liabilities the installments payable within one year. In fact, it may be desirable not to use the captions current assets or current liabilities at all; instead the balance sheet format usually followed by finance companies might be appropriate. In any case, footnote disclosure of the current rentals receivable and current debt maturities would be desirable to permit the reader to understand the situation.

Answers to Examinations, November 1960

ACCOUNTING PRACTICE—PART I

November 2, 1960; 1:30 to 6 p.m.

Solution 1

a. Since ABC Company entered into an agency agreement to act as principal for XYZ Company for the importation of hemp and fiber, ABC Company should not record sales, cost of sales, nor inventories in their general books and records, but rather should record commissions earned and amounts due from the parent company. The required journal entries as of December 31, 1959 to correct the books of account are as follows:

(1) Sales	$8,643,797.36	
Beginning inventory		$ 87,129.90
Ending inventory		79,430.40
Purchases		8,449,294.76
Due from XYZ Company		27,942.30
To relieve the accounts for sales, inventories, and purchases recorded in error.		
(2) Due from XYZ Company	108,000.00	
Commissions earned		108,000.00
To record commissions earned for the year ended December 31, 1959, 60,000 tons @ $1.80:		

$ 87,129.90 ÷ ($7.15 × 20) = 609.3 T
79,430.40 ÷ ($7.20 × 20) = 551.6 T
8,449,294.76 ÷ ($7.18 × 20) = 58.839.1 T
60,000 T

OR

$8,643,797.36 ÷ ($7.27 × 20) = 59,448.4 T
79,430.40 ÷ ($7.20 × 20) = 551.6 T
60,000 T

b. Note to Financial Statement — Under the terms of an agency agreement between ABC Company and XYZ Company (parent company), which became effective January 1, 1959, ABC Company acts as agent for the purpose of purchasing and selling hemp and fiber as specified by and for the account of XYZ Company as principal. Prior to January 1, 1959, ABC Company purchased and sold hemp and fiber for its own account. For financial statement purposes, inventories aggregating $87,129.90 at December 31, 1958 were reclassified as accounts receivable from the parent company as of the beginning of business January 1, 1959.

Solution 2

THE DEEP HOLE MINING CO.

	2nd quarter	*3rd quarter*	*Royalty paid to T. Realty Company*	*Unearned minimum royalty*
Balance—beginning of year				$18,000
1st quarter:				
No shipments, so must pay the quarterly minimum			$ 1,500	1,500
				19,500
2nd and 3rd quarters:				
Calculation of earned royalty rates—per ton:				
Additional royalty rate:				
Market value at destination	$ 10.50	$ 10.00		
Freight to destination	3.10	3.20		
F.O.B. mine value	7.40	6.80		
Base price	4.00	4.00		
Basis for additional royalty	$ 3.40	$ 2.80		
Additional royalty—2% of basis	$ .068	$ .056		
Base royalty rate	.10	.10		
Total royalty rate per ton	$ .168	$ .156		
Tons shipped	100,000	200,000		
Total earned royalty	16,800.00	31,200.00		
2nd quarter:				
Minimum royalty—paid	1,500.00		1,500	
Unearned minimum royalty recovered	$15,300.00			(15,300)
				4,200
3rd quarter:				
Unearned minimum royalty recovered		4,200		(4,200)
Royalty paid		$27,000	27,000	
4th quarter:				
No shipments, so must pay the quarterly minimum			1,500	1,500
Total royalty paid for the year and balance of unearned minimum royalty at the year end			$31,500	$ 1,500

(*Note*: It is important to recognize that $1,500 must be paid for each quarter, regardless of the fact that $6,000 is the total annual minimum.)

Solution 3

(1)

Retained earnings	$1,129,964	
Common stock		$256,810
Premium on common stock		873,154

To record 2% stock dividend on shares issued and outstanding, exclusive of fractional shares. (2,771,600 — 1,000 — 202,500 = 2,568,100 × 2% = 51,362 × $22)

(2)

Retained earnings	89,100	
Cash		89,100

To record payment of cash dividend on fractional shares. (202,500 × 2% = 4,050 × $22)

(3)

Retained earnings	198	
Stock dividends reserved		45
Premium on common stock		153

To record liability for 2% stock dividend on shares reserved for conversion by stockholders of predecessor company, exclusive of fractional shares. (600 — 240 = 360 × 1¼ = 450 × 2% = 9 × $22)

(4)

Retained earnings	132	
Unclaimed dividends		132

To record liability for cash dividend on fractional shares applicable to shares reserved for stockholders of predecessor company. (240 × 1¼ = 300 × 2% = 6 x $22)

Management may decide whether a stock dividend shall be applicable to treasury shares. If the CPA candidate assumes such a decision, the following additional entry would be necessary.

(5)

Retained earnings	440	
Common stock		100
Premium on common stock		340

To record 2% stock dividend applicable to shares held in treasury. (1,000 × 2% = 20 × $22)

Note: The bid price of $21 may be used in recording the payment of the dividend.

Solution 4

Computation of Sales, Cost of Sales and Gross Profit by Years:

	Per cent to Sales	*1957*	*1958*	*1959*	*Total*
Sales (below)	100 %	$ 91,800	$103,200	$134,100	$329,100
Cost of sales	66-2/3%	61,200	68,800	89,400	219,400
Gross profit	33-1/3%	$ 30,600	$ 34,400	$ 44,700	$109,700

Computation of Sales:

	1957	*1958*	*1959*	*Total*
Cash sales	$ 8,500	$ 13,000	$ 15,600	$ 37,100
Collections on accounts—				
1957	74,400			74,400
1958	7,500	80,900		88,400
1959	1,000	8,400	104,400	113,800
Accounts receivable at December 31, 1959	400	900	14,100	15,400
Total	$ 91,800	$103,200	$134,100	$329,100

Computation of Cost of Goods Sold:

Merchandise inventory—December 31, 1956		$ 5,800	
Disbursements—1957	$ 62,500		
—1958	70,600		
—1959	86,900		
	220,000		
Add: Accounts payable—merchandise—December 31, 1959	5,500	225,500	
Total		231,300	
Less: Merchandise inventory—December 31, 1959	9,400		
Accounts payable—merchandise—December 31, 1956	2,500	11,900	
Cost of goods sold for the three-year period 1957 to 1959 .			219,400
Gross Profit for the three-year period 1957 to 1959 (33-1/3% of sales)			$109,700

Solution 5

THE LOADING COMPANY

Cash Forecast

	1961	*1962*	*1963*	*Total*
Non-operating expense:				
Finance charges (Note A)	$ 4,750	$ 250	—	$ 5,000
Interest (Note B)	66,250	86,250	$ 77,500	230,000
Depreciation (@ $.03 per T)	150,000	159,000	168,000	477,000
	221,000	245,500	245,500	712,000
Operating income:				
1961 5,000,000 T @ $.04; 1962 5,300,000 T @ .04; 1963 5,600,000 T @ .04	200,000	212,000	224,000	636,000
Net loss (Note C)	21,000	33,500	21,500	76,000
Depreciation deducted supra	150,000	159,000	168,000	477,000
Cash profit	129,000	125,500	146,500	401,000
Beginning cash balance	100,000	229,000	154,500	100,000
Loan "Drawn-down"	1,700,000	100,000	—	1,800,000
Cash available	1,929,000	454,500	301,000	2,301,000
Expenditures for plant	1,700,000	100,000	—	1,800,000
Principal repayments	—	200,000	200,000	400,000
Cash expended	1,700,000	300,000	200,000	2,200,000
Ending cash balance	$ 229,000	$154,500	$101,000	$ 101,000

Note A

1961—1,000,000 @ 1% × ¼	$ 2,500
500,000 @ 1% × ¼	1,250
200,000 @ 1% × ½	1,000
	$ 4,750
1962— 100,000 @ 1% × ¼	$ 250

Note B

1961— 800,000 @ 5% × ¼	$10,000
1,300,000 @ 5% × ¼	16,250
1,600,000 @ 5% × ½	40,000
	$66,250
1,700,000 @ 5% × ¼	$21,250
1,800,000 @ 5% × ¼	22,500
1,700,000 @ 5% × ½	42,500
	$86,250
1963—1,600,000 @ 5% × ½	$40,000
1,500,000 @ 5% × ½	37,500
	$77,500

Note C

Under present statutory provisions, there would be no federal income tax due for 1961, 1962 or 1963. The operating loss carry-over is $76,000.

Solution 6

a. With respect to the sale of the tractor:

1. A loss of $218 was realized on the sale.

Computation:

Cash	$4,800	
Allowance for depreciation	1,982	
Loss on sale (per books)	218	
Tractor		$7,000

The fair market value should be used for accounting purposes. Depreciation would be computed on the 150% declining-balance method.

The *tax* basis of the tractor to J. W. Gore would be the same as its adjusted basis (book value) in the hands of the donor except that since this basis was greater than the fair market value at the time of the gift, the fair market value should be used for the purpose of determining a *loss*.

Gain or loss for tax purposes	*Basis as in hands of donor*	*Fair market value at date of gift*
Basis as of October 1, 1958	$7,500	$7,000
Depreciation allowed, October 1, 1958 to September 30, 1959 (150% declining balance)	2,124	2,124
Adjusted basis for determining gain or loss	5,376	4,876
Selling price (amount realized)	6,500	4,800
2. Recognized loss		$ 76
3. Recognized gain	$1,124	

4. Basis of new tractor assembly is cost of $9,200.

Computation:

Basis $7,500

$$\text{Depreciation 1958—3/12} \times 150\% \times \frac{\$7{,}500}{5} = \$\ 563$$

$$\text{Depreciation 1959—9/12} \times 150\% \times \frac{\$7{,}500\text{—}\$563}{5} = \underline{1{,}561}$$

$$\$2{,}124$$

Basis $7,000

$$\text{Depreciation 1958—3/12} \times 150\% \times \frac{\$7{,}000}{5} = \$\ 525$$

$$\text{Depreciation 1959—9/12} \times 150\% \times \frac{\$7{,}000\text{—}\$525}{5} = \underline{1{,}457}$$

$$\$1{,}982$$

b. With respect to exchange of trucks:

1. A gain of $2,100 was realized on the exchange.

Computation:

Truck—new	$4,500	
Chattel mortgage payable	2,600	
Allowance for depreciation	2,400	
Truck—old		$5,400
Cash		2,000
Gain on exchange		2,100

Depreciation on truck, using the declining-balance method over a 6-year life, is computed as follows:

Straight line rate—16-2/3%

Declining balance rate—2 × 16-2/3% or 33-1/3%

Depreciation 1958—33-1/3% of $5,400 =	$1,800
Depreciation 1959—1/2 (33-1/3% of $3,600) =	600
	$2,400

2. Gain is recognized to the extent that boot is received, which in this case is $600.

Computation:

Mortgage assumed is considered cash	$2,600
Less cash paid out	2,000
Boot received	$ 600

3. Basis of new truck is $3,000 (old basis of $3,000 less boot received $600 plus gain recognized $600).

c. With respect to the accident:

1. The realized gain of $48 on the business portion (60%) of the automobile is not recognized through application of provisions pertaining to involuntary conversion, but the loss of $80 on the personal portion is recognized.

Computation (Automobile 60% used for business):

Automobile (replaced)	$2,520	
Allowance for depreciation	1,248	
Gain on conversion (not recognized)		$ 48
Automobile (destroyed—60% of $4,000)		2,400
Cash ($2,520—$1,200)		1,320

	Automobile	
	60% Business Use	40% Personal Use
Value before accident	$1,320	$ 880
Adjusted basis	1,152*	1,600
Lesser of loss or adjusted basis	1,152	880
Recovery	1,200	800
Deductible loss		$ 80
Gain (not recognized)	$ 48	

*Computation of adjusted basis of the portion of the automobile used in business:

Cost, January 1, 1958 (60% of $4,000)		$2,400
Depreciation (declining-balance method):		
1958	$960	
1959 (six months)	288	1,248
Adjusted basis		$1,152

2. The basis of the new automobile is $4,152.

Computation (Automobile, 60% used for business):		
Replaced cost	$2,520	
Less gain not recognized	48	
Basis of business portion		$2,472
Computation (Automobile, 40% personal use):		
Replaced cost		1,680
Basis of automobile		$4,152

	Gains or (Losses) from Sales and Exchanges of Business Assets	*Non-Business Casualty (Losses)*	*Capital Gains or (Losses)* Short term	Long term
Sale of tractor	$ (76)			
Exchange of trucks	600			
Involuntary conversion:				
Automobile: Business portion				
Personal portion		$(80)		
Non-business bad debt			$ (500)	
Long-term capital gains				$5,000
Short-term capital gains			1,000	
d. Total "new" capital gains ($5,500)			500	5,000
Net capital loss carry-over			(1,200)	
Excess of short-term capital losses over short-term capital gains, deductible from long-term capital gains			$ (700)	(700)
Net capital gains for 1959				4,300
e. Long-term capital gain deduction				2,150
Taxable as long-term capital gains				$2,150

	Gains or (Losses) from Sales and Exchanges of Business Assets	*Non-Business Casualty (Losses)*	*Capital Gains or (Losses) Short term*	*Long term*
f. Ordinary deductions:				
Casualty loss		$ 80		
Gain from sales and exchanges of business assets	$ 524			

ACCOUNTING PRACTICE—PART II

November 3, 1960; 1:30 to 6 p.m.

Solution 1

a.

ABLE, BRIGHT, COOL AND DAHL

Schedule of Cash Distribution as Cash Becomes Available

	Able	*Bright*	*Cool*	*Dahl*
Capital balance, October 1, 1960	$20,000	$21,500	$18,000	$10,000
Loan balances	6,000	10,000		
Total equity in firm	26,000	31,500	18,000	10,000
Profit and loss ratio	4.0	3.5	1.5	1.0
Equity per unit of profit	$ 6,500	$ 9,000	$12,000	$10,000
Order of sharing in cash installments	4	3	1	2
Total equity	$26,000	$31,500	$18,000	$10,000
(1) First cash to Cool:				
1.5 ($12,000 — $10,000)			3,000	
	26,000	31,500	15,000	10,000
(2) Cash to Cool and Dahl in 1.5:1 ratio before Bright receives cash:				
1 ($10,000 — $9,000)				1,000
1.5 ($10,000 — $9,000)			1,500	
	26,000	31,500	13,500	9,000
(3) Cash to Bright, Cool and Dahl in 3.5:1.5:1 ratio before Able receives cash:				
3.5 ($9,000 — $6,500)		8,750		
1.5 ($9,000 — $6,500)			3,750	
1.0 ($9,000 — $6,500)				2,500
	$26,000	$22,750	$ 9,750	$ 6,500
Ratio	4.0	3.5	1.5	1.0
All additional cash in profit and loss ratio	4.0	3.5	1.5	1.0

b.

	Total	Creditors	Bright, Loan	Cool, Capital	Dahl, Capital
Distribution of $12,700:					
Cash to creditors	$ 3,000	$3,000			
First cash to Cool (1) above	3,000			$3,000	
Second cash to Cool and Dahl (2) above	2,500			1,500	$1,000
Third cash to Bright, Cool, Dahl (3) above	4,200		$2,450	1,050	700
	$12,700	$3,000	$2,450	$5,550	$1,700

c.

Computation of bonus and distribution of net profit:

Net profit after bonus	=	100%
Bonus	=	5%
$23,625	=	105% of net income
$23,625 ÷ 105%	=	$22,500, the net income
$22,500 × 5%	=	$ 1,125, the bonus

	Total	Able	Bright	Cool	Dahl
Bonus	$ 1,125				$1,125
Balance, profit and loss ratio	22,500	$9,000	$7,875	$3,375	2,250
	$23,625	$9,000	$7,875	$3,375	$3,375

Solution 2

XYZ, INC.

Computation of Taxable Income

For the Year Ended December 31, 1959

Net income for the year per books			$ 70,000
Add:			
Net insurance expense applicable to policy on officer's life		$ 800	
Increase in cash surrender value of policy		600	200
Provision for federal income taxes			40,000
Unallowable write-off of organization expenses			1,000
Broker's commission on sale of land (See (1) below)			1,000
Capital losses:			
City of X bonds		1,500	
U.S. Government bonds		1,000	
Capital loss not deductible (Carry forward to 1960)			2,500
			114,700
Deduct:			
Interest on 1956 federal income tax deficiency charged against reserve for federal income taxes		300	
Nontaxable City of X interest		500	
Amortization of emergency facilities in excess of depreciation per books			
Amortization	$5,000		
Book depreciation	1,800	3,200	
Net adjustment of property accounts resulting from the capitalization of repairs by the revenue agent for 1955-1958		4,000	
Ordinary losses:			
Loss on sale of land charged against retained earnings	25,000		
(1) Broker's commission on land sale	1,000	26,000	34,000
Taxable income before applying contribution limitation			80,700
Computation of limitation on contribution deduction		80,700	
Contribution paid		10,000	
		90,700	
5% limitation		4,535	
Contribution paid		10,000	
Limitation (excess may be deducted in future years subject to code restrictions)		4,535	5,465
Taxable income			$ 86,165

Solution 3

RADOT CORPORATION

Worksheet

December 31, 1959

	Balance per Books December 31, 1959		Adjustments				Balance per Audit December 31, 1959				
	Dr.	Cr.		Dr.		Cr.	Dr.	Cr.	Current	Noncurrent	St. Equity
Cash	$ 16,000				(1)	$ 1,000.00	$ 15,000.00		$ 15,000.00		
Accounts receivable	17,000		(2)	$ 1,500.00			18,500.00		18,500.00		
Allowance for bad debts		$ 3,000	(3)	2,000.00				$ 1,000.00	(1,000.00)		
Inventories	10,000				(4)	1,000.00	6,000.00		6,000.00		
					(5)	3,000.00					
Investments	17,000				(6)	3,300.00	13,100.00		10,400.00	$ 2,700.00	
					(8)	600.00					
Fixed assets	148,000				(9)	6,000.00	142,000.00			142,000.00	
Accumulated depreciation		5,000	(9)	6,080.00	(10)	26,640.00		25,560.00		(25,560.00)	
Accounts payable		6,000	(4)	1,000.00				5,300.00	(5,300.00)		
					(1)	300.00					
Notes payable		14,000						14,000.00	(12,000.00)	(2,000.00)	
Capital stock		75,000			(12)	25,000.00		100,000.00			$(100,000.00)
Retained earnings		105,000	(1)	1,300.00	(2)	1,500.00					
			(5)	3,000.00	(3)	2,000.00					
			(6)	3,300.00	(7)	25.00					
			(8)	600.00	(9)	80.00					
			(10)	13,320.00							
			(10)	13,320.00*							
			(11)	150.00							
			(12)	8,000.00							
			(13)	17,043.40							
			(14)	13,291.20				35,280.40			(35,280.40)
Accrued interest receivable			(7)	25.00			25.00		25.00		
Accrued interest payable					(11)	150.00		150.00	(150.00)		
Treasury stock**			(12)	24,500.00			24,500.00				24,500.00
Premium on stock**					(12)	7,500.00		7,500.00			(7,500.00)
Accrued federal income tax					(13)	17,043.40		17,043.40	(17,043.40)		
Deferred federal income tax					(14)	13,291.20		13,291.20		(13,291.20)	
Totals	$208,000	$208,000		$108,429.60		$108,429.60	$219,125.00	$219,125.00			

*Prior year.

**Treasury stock may be carried at $27,000 and Premium on stock at $10,000.

Inventories

Net realizable value = 90% of sales price

$9,000 = .90 X
X = $10,000

Sales price = $10,000
Gross profit on sales = .40 X $10,000 = $4,000
Sales price — gross profit = $10,000 — $4,000 = $6,000
Cost = $6,000
Market = $7,000
Use cost since less than market.

Accumulated Depreciation

Balance	$ 5,000
Depreciation for 2 years [2 X 10% ($148,000 — $14,800)]	26,640
Deduct: Accumulated depreciation on equipment sold— 2 X 10% ($6,000 — $600)	(1,080)
Eliminate $5,000 credit in error	(5,000)
Balance per audit	$25,560

Deferred Federal Income Tax

Allowance for depreciation:		
Per tax basis:		
1958—20% X $148,000		$29,600
1959—20% ($148,000 — $29,600)		23,680
		53,280
Less: Depreciation on equipment sold:		
1958	$1,200	
1959	960	2,160
		51,120
Per books:		
1958—10% ($148,000 — $14,800 salvage)		13,320
1959		13,320
		26,640
Less: Depreciation on equipment sold		1,080
		25,560
Difference		25,560
Corporate tax rate		52%
Deferred federal income tax		$13,291.20

Solution 4

a. Gross margin calculations:

Cash sales	$126,000	
Installment sales (gross)	265,000	
Interest on installment sales	(15,000)	
Cash sales equivalent		$376,000
Inventory, January 1, 1959	58,060	
Purchases 1959	209,300	
Total	267,360	
Inventory, December 31, 1959	33,300	
Cost of goods sold		234,060
Gross profit (on cash price equivalent)		$141,940

Gross profit percentage = $141,940 ÷ $376,000 = 37.75%.

b. Schedule of a contract of $1,060:

Installment Number	*Cash Sale Price Equivalent*	*Contract Balance*	*Interest Earned**	*Cash Collected*
1	$1,000.00	$1,060.00	—	$265.00
2	735.00	795.00	$7.35	53.00
3	689.35	742.00	6.89	53.00
4	643.24	689.00	6.43	53.00
5	596.67	636.00	5.97	53.00
6	549.64	583.00	5.50	53.00
7	502.14	530.00	5.02	53.00

*Interest is 1% of the "cash sale price equivalent" unpaid at each installment.

c. Net gain or loss on defaults:

Installment sale price		$ 1,060.00	
Less: Interest on contract		60.00	
Cash price			$1,000.00
Less: Down payment		265.00	
Collections	$159.00		
Less interest	20.67	138.33	
			403.33
Unrecovered portion cash price			$ 596.67
Less:			
Unrealized gross margin $596.67 @ 37.75%		225.24	
Repossessed sales		230.00	
Repossessed inventory		180.00	
			635.24
Net gain on defaults			$ 38.57

d. Realized gross profit:

Cash sales $126,000 @ 37.75%		$47,565.00
Installment sales:		
Down payment $66,250 @ 37.75%		25,009.38
Default installments $138.33 @ 37.75%		52.22
Installments collected	$79,182.00	
Less interest earned	9,252.84	
	69,929.16	
	@ 37.75%	26,398.26
Realized gross profit		$99,024.86

Interest earned:

$$\frac{\$265{,}000 - \$1{,}060}{106\%} = \$249{,}000 \times \$37.16 \text{ in six installments per}$$

$\$1{,}000 = \$9{,}252.84$

Solution 5

a.

ABC MANUFACTURING COMPANY
Verification of Pricing of Work-in-Process and Finished Goods Inventory
Audit December 31, 1959

1. *Computation of Effective Production*

	Materials	*Labor*	*Overhead*
Units completed during year	510,000	510,000	510,000
Units on hand at end of year—50% completed as to conversion costs	90,000	45,000	45,000
	600,000	555,000	555,000
Units on hand at beginning of year	(100,000)	(80,000)	(80,000)
Effective production 1959	500,000	475,000	475,000

2. *Unit Costs of Production*

	Total			
Current manufacturing costs	$2,295,625	$550,000	$997,500	$748,125
Effective production (Part 1)	—	500,000	475,000	475,000
Unit cost	$4.775	$1.10	$2.10	$1.575

3. *Pricing of Inventories*

		AMOUNTS		
	Units	*Total*	*Finished Goods*	*Work-in-Process*
Valuation of ending inventory—				
Finished goods—				
Good units @ $4.775	100,000	$477,500	$477,500	—
Defective units @ $1.00	10,000	10,000	10,000	—
Work-in-process—	90,000	—	—	—
Materials @ $1.10	—	99,000	—	$ 99,000
Labor @ $2.10 @ 50%	—	94,500	—	94,500
Overhead @ $1.575 @ 50%	—	70,875	—	70,875
Per pricing test	200,000	$751,875	$487,500	$264,375
Per books	200,000	835,380	504,900	330,480
Adjustment	—	$ 83,505	$ 17,400	$ 66,105

b.

Cost of sales (retained earnings if books have been closed)	$ 83,505	
Finished goods inventory		$ 17,400
Work-in-process		66,105

Solution 6

CITY OF LARKSPUR

Electric Department

Worksheet of Transactions and Funds

For Fiscal Year Ended June 30, 1960

	Balance 6/30/59	Transactions				Balance 6/30/60	Net change for year Dr. (Cr.)	Adjust-ment Dr. (Cr.)	Working Capital Increase (Decrease)	Source	Application
Revenue Fund:											
ASSETS:											
Electric plant	$50,000,000	(5)	$ 1,000,000			$56,000,000	$ 6,000,000				$ 6,000,000
		(13)	5,000,000								
Allowance for depreciation	10,000,000			(a)	$ 1,010,000	(11,010,000)	(1,010,000)	$1,010,000			
	40,000,000					44,990,000					
Construction in progress	500,000	(3)	750,000	(5)	1,000,000	250,000	(250,000)				(250,000)
		(8)	2,800,000	(13)	5,000,000						
		(11)	2,200,000								
Land	5,000,000					5,000,000	—0—				
	45,500,000					50,240,000					
Bond cash on deposit		(7)	5,000,000	(8)	2,800,000						
				(11)	2,200,000						
Cash on deposit	2,250,000	(10)	10,500,000	(6)	4,280,000	4,300,000	2,050,000		$2,050,000		
				(12)	3,045,000						
				(b)	1,125,000						
Due from customers	2,120,000	(1)	10,700,000	(10)	10,500,000	2,320,000	200,000		200,000		
Other current assets	130,000	(2)	2,950,000	(4)	2,790,000	140,000	10,000		10,000		
				(9)	150,000						
	4,500,000					6,760,000					
	$50,000,000					$57,000,000					

Solution 6 (*continued*)

CITY OF LARKSPUR

Electric Department

Worksheet of Transactions and Funds

For Fiscal Year Ended June 30, 1960

	Balance 6/30/59	Transactions				Balance 6/30/60	Net change for year Dr. (Cr.)	Adjustment Dr. (Cr.)	Working Capital Increase (Decrease)	Source	Application
Revenue Fund:											
LIABILITIES:											
5% electric revenue bonds	$20,000,000			(7)	$ 5,000,000	$25,000,000	$(5,000,000)			$5,000,000	
Accounts payable	3,270,000	(12)	$ 3,045,000	(2)	2,950,000	3,925,000	(655,000)		$ (655,000)		
				(3)	750,000						
	23,270,000					28,925,000					
Income and expenses:											
Sales				(1)	10,700,000	10,700,000					
Fuel used		(4)	2,790,000			(2,790,000)					
Salaries		(6)	4,280,000			(4,280,000)					
Operating supplies		(9)	150,000			(150,000)					
Depreciation		(a)	1,010,000			(1,010,000)					
Interest		(b)	1,125,000			(1,125,000)					
						1,345,000	(1,345,000)	($1,010,000)		2,355,000	
Accumulated earnings	26,730,009					26,730,000					
	26,730,000					28,075,000					
	$50,000,000					$57,000,000					
									$1,605,000		1,605,000
										$7,355,000	$7,355,000

AUDITING

November 3, 1960; 8:30 a.m. to 12 m.

Solution 1

a. (1) The primary responsibility for the correctness of statements lies with management; written representations emphasize this point.
   (2) A letter reduces to and confirms in writing information which is asked of management. It will prevent misunderstanding between the client and the auditor and remind management that all appropriate information should be revealed to the auditor.
   (3) The letter provides evidence for review or subsequent use that the auditor has made the proper inquiries concerning matters which may not be readily disclosed in the accounting records.
   (4) Some items as to which the representations are sought, are not readily observable or found in the records of the firm but their existence would materially affect the fairness and accuracy of the financial reports.
   (5) For an initial audit, such representations prove valuable in establishing a starting point in building a permanent file.

b. Client representations *do not* in any way relieve the auditor of following standard audit procedures or reduce his responsibilities when expressing an opinion on the client's statements.

Solution 2

a. The consigned stock inventory should be segregated or identified and physically counted by the client. Care should be taken to assure an inventory as accurate as the client's own inventory because of the influence on other factors in the financial statements. The following audit procedures should be followed:
   (1) Review the consignment contract for terms and types of paint consigned.
   (2) Make representative test counts of consigned paint. Trace test counts to final inventory papers.
   (3) Ascertain amount of consigned paint sold by Star Wholesale Co. but not paid for.
   (4) Ascertain amount of consigned paint paid for by Star Wholesale Co. and on hand.
   (5) Determine if the consigned paint on hand and not paid for has been recorded in the accounts payable register.
   (6) Confirm with the Coaton Paint Co. the shipments and payments made.
   (7) Review appropriate records for compliance with contract terms for such allowances as discount, freight charges, advertising, salesmen bonuses, etc.

b. The following balance sheet adjustments might be required depending upon your audit findings:
   (1) Both the inventory and accounts payable should be reduced by the consigned inventory on hand which is included in accounts payable. The merchandise is not owned by the Star Wholesale Co. nor does a liability exist until the paint is sold.
   (2) A payable should be established for consignment sales made but not remitted to the Coaton Paint Co.
   (3) A receivable should be established for consigned merchandise paid for and on hand, with a corresponding reduction of inventory.

c. In view of your discovery of internal control weakness because the accounting department had not been advised of the consignment contract, the following procedures of the company should be reviewed for possible adoption or expansion:
   (1) Communication between departments. The accounting department should be advised of contracts having a bearing on accounting functions. Such contracts would include purchases, sales, advertising, leases, royalties, consignments, etc.
   (2) Preparation of purchase orders. A purchase order for consigned merchandise should include the specification in its terms.
   (3) Processing of invoices for payment. The clerical operation of checking prices and terms to purchase orders or other authorizations is subject to review.
   (4) Approval of invoices for payment. The method of approving invoices for payment is subject to scrutiny for overlooking the consignment feature.
   (5) The method of reporting and paying consignment sales. It is possible there is no procedure established for consignments.
   (6) Fire insurance coverage. Because the merchandise is not the property of the client, it might not be covered under existing policies.

Solution 3

a. (1) To ascertain that the company's procedure for handling expenditures is sufficient to provide proper control.
   (2) To satisfy the auditor that proper accounting and distribution (accuracy and classification) thereof is accorded expenditures.
   (3) To satisfy the auditor that the prescribed procedures are followed.
   (4) To satisfy the auditor as to the validity of expenditures.

b. For each voucher examined the following should be ascertained:
   (1) Authenticity of invoice, receiving reports and other attached data.
   (2) Evidence of comparison by client of prices on invoice to purchase order.
   (3) Prices paid were presumably not excessive.
   (4) Evidence by client of proof of clerical accuracy.
   (5) Agreement of description and quantity on all supporting documents.

(6) Proper computation of sales or use tax, where applicable.
(7) Cancellation of supporting documents to prevent their re-use.
(8) Accuracy of account distribution by reference to the chart of accounts.
(9) Vouchers prenumbered and all accounted for.

Tests of disbursement records should be made also to insure that:

(10) Proper approval for payment is indicated.
(11) Allowable discounts have been taken.
(12) Cancelled checks in payment of vouchers are in order as to number, date, payee, amount, signature, endorsement and perforation.

Solution 4

1. Are purchases and sales of investments authorized by the Board of Directors?
2. Has the Board of Directors delegated the authority to authorize purchase or sales of investments to an officer of the company?
3. Are purchases from and sales to officers and stockholders prohibited?
4. Do purchases or sales at exceptions to quoted market price plus brokerage and taxes, where applicable, require approval of the Board of Directors?
5. Are all designated and responsible officials covered by insurance and fidelity bonds?
6. Are registered securities held in the name of the client?
7. Is a designated employee responsible for the custody of the investments?
8. Is the custodian of investments independent of general ledger and cash functions?
9. Are all investment documents kept in a safe-deposit box or vault?
10. Must more than one person of equal status be present to open the box or vault?
11. If an independent custodian is used, is a monthly report received by the client?
12. Is the custodian of securities informed of partial reduction in face amount of securities by persons independent of those maintaining detailed records or securities?
13. Do transactions by the custodians require the authorization of more than one responsible official?
14. Does the accounting department maintain a detailed investment register including stock certificate numbers, bond numbers, etc.?
15. Are duplicate records maintained by the custodian?
16. Is a reconciliation of the detailed records of investments with the general ledger control prepared and reviewed periodically?
17. Does the accounting department prepare in advance income schedules from investments and keep them up to date throughout the year?
18. Are securities held as collateral, or held for other parties or otherwise, properly segregated, physically and in the records?
19. Are securities and other investment documents periodically inspected (or confirmed) and reconciled with accounting records?
20. Is approval of a responsible official required for (a) write-off of worthless investments, (b) release of collateral, and (c) receipt and delivery of securities?

21. Is an annual report on individual investments and the income therefrom, prepared and made to the Board of Directors?

Solution 5

a. The purposes of these audit procedures are:
   1. To substantiate the validity of the asset "cash" in the balance sheet, as it may substantially consist of "cash in transit" from several sales divisions.
   2. To determine proper cash "cut-off," i.e., to detect any unintentional errors overstating or understating cash between the current and the following accounting period.
   3. To disclose "kiting" (if any), e.g., perpetrated by the home office cashier in collusion with one or more sales divisions employees.
   4. To determine that sales divisions adhere to the company's policy with regard to transfer amounts.
   5. To test for any unauthorized or improper use of cash by sales divisions, particularly checking the timeliness of transfers.

b. *Audit Program for Sales Divisions*

Audit Steps

1. Prepare a schedule of transfer payments made by the branch for a period covering two weeks prior and two weeks after the end of the fiscal period showing:
   Check number
   Date of entry in cash disbursements books
   Amount of check
   Date of perforation by paying bank
   Transfer checks outstanding at the date of cut-off
   Transfer checks outstanding at the date of reconciliation
2. Compare dates of issue on cancelled checks and of entries; they should be identical.
3. Trace and compare dates of perforation and dates of payment on the bank statement and the "cut-off" statement; they should be identical.
4. Compare dates of issue of checks to dates of perforation looking for:
   (a) unusual delays in payment,
   (b) discrepancy in accounting periods for the two dates.
5. Scan cancelled checks and cash disbursements records during the year for:
   (a) names of payees,
   (b) consecutive number of checks
   to determine whether any other payments than regular transfers to main office were made from this account.
6. Reconcile individually several transfers during the year to corresponding collections presumed to be transferred as of each individual date.
7. Reconcile total collections for the year to total transfers.

8. Test check the timeliness of issuance of individual checks which should have been issued twice a week according to the company's policy.
9. Test check copies of remittance lists detailing collections and of transfer advices (to home office) to cash book.
10. Prepare a list of comments as to results of the audit particularly noting:
    (a) discrepancies in dates in steps 2, 3 and 4,
    (b) irregularities in all other steps.

Solution 6

a.

RACES CORPORATION

Notes to Financial Statements

December 31, 1959

Note 1. The corporation completed the construction of a one-mile track and related facilities on December 15, 1959. On January 15, 1960, legislation was enacted by the state making betting illegal. Elimination of betting will substantially reduce the level of activity previously anticipated for the track's opening season in 1960. Management now (February 1, 1960) believes that 1960 operating income will equal or slightly exceed 1960 operating expenses before providing any depreciation on properties subject thereto.

Note 2. Referenced to Land in Assets.
The land is reported on the balance sheet at historical cost; however, its current market value approximates $60,000.

Note 3. Referenced to Grading and Track Improvements, Grandstand, Buildings and Racing Equipment in Assets.
These assets are reported on the balance sheet at historical cost; however, in view of the January 1960 legislation prohibiting betting and the limited alternative uses of these assets, the ability of the corporation to recover the cost of these depreciable properties from future operations is questionable.

Note 4. Referenced to Installment Notes Payable — 6%.
The note contract specifies that $50,000 is to be paid December 31, 1960 and $50,000 on December 31, 1961.

Note 5. Referenced to Grading and Track Improvements, Grandstand, Buildings and Racing Equipment in Assets.
The double declining-balance method (an accelerated method) of computing depreciation has been adopted. No depreciation was taken in 1959 because all racing equipment was delivered in late December after the completion of the track and facilities on December 15, 1959.

b. *To the Board of Directors*:

Because of the circumstances set forth in the notes to the balance sheet we cannot express an opinion as to whether the accompanying balance sheet fairly presents the financial position of the company at December 31, 1959. However, in our opinion, the accompanying balance sheet presents fairly cash, accounts receivable, prepaid expenses, cost of the property, organization costs, accounts payable and installment notes payable as of December 31, 1959.

Jones and Jones,
Certified Public Accountants

February 1, 1960

c. Reasons for Disclaimer:

Due to the impending maturity of installment notes the company is subject to financial distress if at least two conditions are not fulfilled in the future: (a) obtaining cash through sale of stock, and (b) successful operation of the track. In view of these circumstances and of those set forth in Note 3, it is not possible to give an opinion on the financial position. However, we can give our opinion as to the individual items contained in the balance sheet as indicated in the opinion. Since legislation making betting illegal has been enacted, the salability of the stock and the profitable operation of the track have probably been adversely affected.

Solution 7

a. In a coinsurance type policy, the insured is required to maintain insurance coverage to the extent of the coinsurance clause; failure to do so results in the insured's sharing the risk with the insurance company. The coverage requirement is determined as the percentage stipulated in the coinsurance clause applied to the insurable value of the asset at the date of the fire. In a reporting-form type policy, the full value of the property must be insured at all times. Just as there is a penalty in the coinsurance clause for failure to carry the percent of actual value required, so, too, in the full value form.

Thus, in the coinsurance policy, the insurance company's liability is limited to the ratio of the face amount of the insurance to the required amount. But in the full-value reporting-form, it is limited to that proportion of the loss that the last reported value bears to the actual value as of the date of the report.

b. 1. Values overlooked or not inventoried:
   (a) Goods held in trust for others, especially customers' goods.
   (b) Miscellaneous supplies.
   (c) Merchandise in receiving and marking rooms not entered on books.
   (d) Difference between "book" and insurable value of fixtures.
   (e) Cost of freight, handling, marking, placing on shelves.
   (f) Personal property of insured and employees.

(g) Full value of lay-away sales; and undelivered C.O.Ds.

2. Increases in value:
   (a) Appreciation in market value.
   (b) Seasonal inventory build-up, particularly build-up prior to the end of a month.
   (c) Shipments received but not recorded.
   (d) Inventory transferred from one building to another.

3. Inefficient inventory methods and insurance records:
   (a) Inaccurate computation of monthly inventory.
   (b) Inventory at two or more locations with specific insurance at each location.
   (c) No check on insurance expirations.
   (d) Delaying ordering insurance until inventory taking is completed.

4. Deliberate intention to insure for less than full value:
   (a) Limiting insurance to coinsurance percentage of value.
   (b) Belief that total loss cannot occur.
   (c) "Economizing" on insurance cost.

5. Nonconcurrent policies covering same property:
   (a) Combination of blanket and specific insurance.

COMMERCIAL LAW

November 4, 1960; 8:30 a.m. to 12 m.

Solution 1

	a	*b*	*c*	*d*	*e*
1.		X	X	X	X
2.					X
3.					X
4.	X		X		
5.					X
6.	X	X	X	X	
7.				X	
8.	X				
9.	X	X	X	X	
10.			X	X	
11.			X		
12.	X				
13.			X		
14.	X				
15.			X		

Solution 2

	a	*b*	*c*	*d*	*e*
1.	X	X			
2.		X			
3.			X		
4.	X	X			
5.		X			
6.					X
7.	X	X	X	X	
8.		X	X	X	
9.				X	
10.			X		
11.			X		
12.	X	X	X	X	X
13.	X	X		X	X
14.		X	X	X	
15.	X	X			

Solution 3

	a	*b*	*c*	*d*	*e*
1.	X	X	X	X	
2.		X			
3.	X			X	
4.	X		X	X	
5.			X		
6.	X	X	X	X	
7.		X	X	X	
8.	X	X	X	X	
9.			X		
10.	X	X	X	X	
11.	X	X		X	
12.			X		
13.					X
14.		X	X		
15.			X		

Solution 4

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
a	X				X		X		X					X	X
b	X	X	X	X	X			X	X	X	X	X		X	X
c		X	X		X			X	X	X	X	X			
d	X	X	X		X		X	X	X	X		X	X		X
e						X	X								

Solution 5

a. 1. A corporation is a domestic corporation in the state in which it was formed. Thus, Acme Industrial Corporation would be a domestic corporation in State X.
   2. A foreign corporation is a corporation doing business in any state or country other than that in which it was incorporated. Thus, Acme Industrial Corporation would be a foreign corporation in State Y.

b. The usual criteria to ascertain whether or not a foreign corporation is doing business are: permanent, substantial, and continuous business engaged in as contrasted with mere isolated or casual transactions. In addition activities such as the installation of permanent facilities, e.g., a warehouse for storage of goods, delivery from local stock and providing for local service and maintenance has definitely been held to constitute "doing business."

c. There are several sanctions or penalties that may be applied against Acme, namely:
   1. Denial of the right to do business within the state.
   2. Deprivation of the right to sue in the courts of the state, thus making the corporation's contracts unenforceable.
   3. Fines against the corporation, officers, stockholders, or agents.

d. The four factors necessary in order to have a *de facto* corporation are:
   1. A valid law in existence under which the corporation could be formed.
   2. A bona fide attempt to organize.
   3. Some minor error or omission was made in the process of incorporation.
   4. An exercise or use of the corporate powers.

Solution 6

a. Able cannot collect on the fire insurance policy taken out with the Indemnity Insurance Company. In order to have a valid policy rather than a mere wage, insurance law requires that the party taking out the policy have an insurable interest in the subject matter of the policy. Able did not have such an insurable interest in Blackacre or its buildings at the time he took out the policy, nor, more important, at the time of the destruction of the property. The contractual rights in Blackacre, which would have satisfied the insurable interest requirement, were unenforceable in that the Statute of Frauds requires that contracts for the sale of interest in land be in writing. Therefore, having no legally recognized interest, nor any other interest which would fulfill the insurable interest requirement, the insurance company was correct in refusing to pay on the policy.

   Despite the fact that Able may not collect on the policy for the destruction of the building, he does have the right, based on quasi contract, to a return of the premium he paid because of unjust enrichment.

In jurisdictions holding an oral agreement is merely voidable under the Statute and that therefore the Statute is a personal defense that must be pleaded, Able would have an insurable interest and could recover.

b. 1. *Binder*: A memorandum of an agreement for insurance, intended to give temporary protection, pending investigation of the risk by the insurer in order to determine whether or not to issue a formal policy. Although most commonly used in fire or automobile insurance, a binder may be used in any type of insurance.
2. *Open policy*: A type of property insurance policy in which the value of the property is not settled in the policy, but is left open to be determined at the time of the loss. Such policy may contain a statement of the maximum the company will be liable for in the event of loss.
3. *Sound health clause*: This clause is used in life and health insurance which states that the policy shall not take effect unless and until the application is approved by the home office and the policy is delivered to the insured while he is in good health. It protects the insurer against a change in the health of the applicant during the period commencing with submission of the application until delivery of the policy.
4. *Hostile fire*: This term is used in fire insurance and refers to fire which breaks out where not intended or breaks out from where it was intended to be confined and becomes a hostile element.
5. *Warranty*: This term is used in all types of insurance. It refers to any term embodied in the insurance contract which prescribes as a condition precedent to the insurer's liability the existence of a fact which lessens the risk of the occurrence of an insured event or the nonexistence of a fact which increases such risk.

Solution 7

a. The parties have entered into a suretyship or guaranty relationship with Daniel as principal debtor, Lucas as creditor and Frank as surety or guarantor. In such a relationship the principal debtor is the primary obligor on the debt or duty owed to the creditor and bears the ultimate burden of performing. The creditor has the right to performance by the principal debtor or upon default to proceed against the surety. The surety promises to perform upon the default of the principal debtor and thus is secondarily liable to the creditor.

b. In the event of default by the principal and performance by the surety, the surety has a right to reimbursement or indemnity against the principal. In this case the surety (Frank) has the right to reimbursement (from Daniel) for the $10,000 damages he paid to Lucas.

c. Even though Frank completed the building he may not retain the profit that resulted from his performance. The surety may only recover $8,000, the amount which he expended or paid to the creditor in order to satisfy the obligation. Any profit that results belongs to the principal.

Solution 8

a. A fixture is something which was originally personal property but which was annexed to the land so as to become a part of the real property.

b. The three rules or tests to determine whether personal property has been converted to real property are:

1. *Mode and degree of annexation.* There must be an actual attachment to the land, the more permanent the attachment the more likely the chattel has become real property. In this connection consideration is given to the difficulty involved in and damage resulting from removal.
2. *Adaptation to or usefulness of the personal property in respect to the purpose for which the real property is used.* Consideration is given to whether the chattel was placed upon the land for the purpose of improving, making more valuable or extending or changing the use of the land in question.
3. *The intention of the parties.* This test is considered to be the key test, however, it is often difficult or impossible to ascertain whether the parties intended to make a permanent addition to the real property. Thus the intention must be determined from the agreement, the nature of the articles annexed, the relation and situation of the party making the annexation and resort to the two tests discussed above.

c. Based upon the tests set forth above it appears that the property definitely was real property and therefore included in the real property mortgage held by the Mortgage Savings and Loan Bank. The facts indicate that the intent was to make a permanent improvement of the real property and the mode of annexation appears to be such that it would be both difficult and harmful to remove the integrated watering and sprinkling system. Finally, without this system the land could not function as a cranberry farm, thus the property in question is not only necessary and valuable, but vital to use of the real property.

Solution 9

a. 1. No. In the principal case Terrance is merely an incidental beneficiary and as such he is not entitled to recover for breach of the contract between Regis and Mike.

2. The three kinds of third party beneficiaries are donee, creditor and incidental beneficiary.
   (a) A donee beneficiary is a person, other than the promisee who will benefit from the performance of the contract, and it appears from the terms of the contract, in view of the accompanying circumstances, that the purpose of the promisee, in obtaining the promise of performance, is to make a gift to the beneficiary.
   (b) A creditor beneficiary is a person other than the promisee, who will benefit from the performance of a contract, and it appears from the

terms of the contract, in view of the accompanying circumstances, that the promisee owes an obligation to the beneficiary which he intends to discharge by contracting with the promisor for performance to be rendered to the beneficiary.

(c) An incidental beneficiary is a person, not a party to the contract between promisee and promisor, who may be incidentally benefited by performance of the contract but who, by the terms of the contract, in view of the accompanying circumstances, is not intended to derive any benefits therefrom.

b. A *contract implied in fact* is a contract which is inferred from the acts and conduct of the parties, the circumstances being such that it is a reasonable, or even necessary, assumption that a contract existed between the parties by tacit understanding. A *quasi contract* unlike a true contract is not based upon the apparent intention of the parties to undertake the performance in question, nor is it a promise; instead, it is an obligation created by law for reasons of justice to prevent unjust enrichment.

THEORY OF ACCOUNTS

November 4, 1960; 1:30 to 5:00 p.m.

Solution 1

Item No.	*A*	*B*	*C*	*D*	*E*	*Item No.*	*A*	*B*	*C*	*D*	*E*
1.			X			11.	X				
2.			X			12.				X	
3.	X					13.	X				
4.	X					14.	X				
5.	X					15.				X	
6.	X					16.					X
7.					X	17.	X				
8.		X				18.	X				
9.			X			19.	X				
10.		X				20.				X	

Solution 2

1. Inventory recorded at cost.
   (a) Revenue is realized at the point of sale or possibly at a later period.
   (b) Merchandise held for cash or account sales should be recorded at cost under normal circumstances.
   (c) Cost is the usual method of valuing inventory and is used to defer the realization of revenue whenever there is some uncertainty until the time and amount of the sale can be ascertained. To recognize income in advance of this ordinarily would mean that revenue is recognized based upon production rather than upon completion of the production and sale process.

2. Accounts receivable recorded at selling price with an account called "Deferred gross profit."
   (a) Net revenue is realized at the point of collection of cash.
   (b) The deferral of gross profit on installment sales.
   (c) The realization of income is deferred until the collection of cash because of the unusual uncertainty regarding the collection of the sales price and because of material expenses which may be incurred after the date of sale, the amount of which cannot be estimated with accuracy.

3. Inventory recorded at selling price less a normal mark-up.
   (a) Revenue is realized at the point of sale or later.

(b) The retail inventory method.
(c) A normal mark-up is deducted to arrive at estimated cost, or estimated cost or market whichever is lower. This estimated cost should be used to defer the realization of revenue whenever there is some uncertainty regarding the sales price or the amount of expenses to be matched against the revenue.

4. Inventory recorded at the net figure of selling price less costs to complete.
   (a) Revenue is realized at the point of production except for an amount equal to the estimated costs necessary to complete.
   (b) A specific job produced under contract in which costs will exceed the contract price.
   (c) Inventory should be recorded at net realizable value when there is an assured contract price and when additional expenses can be estimated with certainty and such net realizable value is less than cost.
5. Inventory recorded at realization value (selling price).
   (a) Revenue is realized at the point of production.
   (b) The production of gold or wheat.
   (c) Inventory should be recorded at selling price and the revenue realized at the point of production whenever there is an assured price for the product and when additional expenses are negligible.

Solution 3

Balance Sheet—The balance sheet is a statement of financial position of any business at a given time. The balance sheet generally lists assets on the left, and liabilities and owners' equity on the right. The primary factor which distinguishes the balance sheet from the other two statements is the "going concern" assumption. One of the assumptions underlying the accounting conventions followed in preparing a balance sheet is that the business entity under consideration is a going concern and will continue to operate indefinitely into the future.

Statement of Affairs—Basically, the statement of affairs is a balance sheet prepared under the condition that the going concern assumption has been dropped. It is assumed that the company intends to liquidate and sell its assets and pay off its creditors. Thus asset values used are the estimated amounts realizable through sale or other disposition; and liabilities are classified in accordance with their priority in the event of liquidation, and relative security in the form of liens against particular assets of the business.

Statement of Realization and Liquidation—This is a statement of accountability, prepared by a receiver or other person, which attempts to account for the activities of the receiver during a given period of time. It is in part a balance sheet (assets not realized and liabilities not liquidated); in part a statement of operations (supplementary credits and operating charges) and in part a statement indicating the amounts realized from the liquidation of assets and the gain or loss from book value which resulted from this liquidation.

Solution 4

1. The percentage of direct labor cost is one of the oldest and most common methods of applying overhead. Many manufacturing expenses are consumed on a time basis, such as light, rent, insurance and power. The more hours spent on a job, the higher the labor and manufacturing expenses charged to the job. The direct labor cost method is economical and easy to use since all requisite data are available from the payroll summary. No additional record keeping is needed.

   An objection to this method is that it ignores contributions of value to the product by factors of production other than direct labor. In some operations machinery, and not labor, represents the prime production factor. The use of a percentage of direct labor cost in an instance such as this results in faulty distribution of overhead by charging operations performed by highly-paid laborers with proportionately more overhead than the same operations performed by lower-paid laborers.

2. The rate per direct labor hour method overcomes some of the objections to the labor cost method arising from differences in labor rates. However, the use of this method necessitates the collection of additional data, namely direct labor hours per job, department or product. The method fails to consider contributions of value to the product by factors other than direct labor. As long as labor operations contribute the chief factor in production process, the direct labor hour method can be accepted.

3. The percentage of direct material cost method has limited use. This method can be used where grades and prices of raw materials do not fluctuate widely, where quantity and cost of material in each product is reasonably uniform, and where processing is uniform. In many companies, this method is used as a "secondary rate" to distribute a portion of overhead expenses, namely, cost of material handling, purchasing, receiving, testing and storing.

   The major objection to this method is that there is no logical relationship between overhead and cost of material consumed. Consideration of the time factor is entirely lacking. When prices of raw materials differ widely, the products made from high priced materials are charged with more overhead. Finally, this method is not equitable if the production process is not uniform for all material.

4. The rate per unit of product is the simplest and most direct method of applying overhead to a product. The usefulness of this method is limited to those situations in which one product, or a few closely related products possessing a common denominator, such as weight, are manufactured. Where there is no common denominator, one may be devised by using a weight factor or some point basis.

5. The percent of prime cost (the sum of direct material and direct labor) method is simple and easy to use, since all data are available without additional

compilation. In many companies, it is used as a departmental rate only as opposed to an over-all rate.

An objection to this method is that it does not make use of the time factor in applying overhead. There is no logical relationship between major portions of overhead cost and dollar value of raw materials used. This method combines the disadvantages of the material cost method with those of the direct labor dollar method.

6. Where machinery is the main factor in production, the machine hour method constitutes the best way to apply overhead. This method uses time as a base in applying overhead and pinpoints the expense to individual machines.

   An important objection to the machine hour method is that additional information not otherwise needed must be provided in detail. Records of machine time for each operation must be maintained. Since this increases the cost of the accounting procedures, some concerns do not find it practicable to use a machine hour rate.

   By its very nature this method precludes use of a blanket rate. Individual or group machine rates must be used, thus increasing the detailed cost work. The machine hour method is not universally applicable; it can be used only for costing those operations performed by machinery.

Solution 5

a. Depreciation based upon replacement cost and the last-in, first-out pricing of inventories both attempt to prevent variations in profits due to changes in prices of fixed assets and materials from being reported on the income statement. This common objective can be further described as an effort to make the income statement more meaningful as a measure of current income by matching *current* costs with *current* revenue.

b. Several conditions must prevail in order for LIFO to achieve this objective.
   1. Inventory acquisitions must be made at frequent intervals. The longer the period of time elapsing between acquisition and sale, the greater the discrepancy between acquisition cost used for cost of sales and the replacement cost.
   2. Turnover must be rapid.
   3. The production cycle, if any, must be short.
   4. A direct relationship should exist between the cost of material and the sales price.
   5. The quantity of ending inventory should be at least as large as the beginning inventory. If the ending inventory is smaller than the beginning inventory, part of the cost of goods sold will be based on beginning inventories.

c. The basic monetary concept underlying accounting and financial statements primarily responsible for the development of these methods of accounting is the postulate of the stable dollar. If accountants should replace the concept that the dollar is a stable measuring unit with the assumption that the dollar is unstable and that accountants must adjust the financial reports as the value of the dollar changes, the use of devices such as depreciation based on replacement costs and LIFO pricing would be unnecessary.

d. The following arguments have been presented in opposition to the modification of financial statements for price level changes:
   1. The conventional treatment is deep-rooted in practice and in law.
   2. There is an exaggeration of the significance of the problem.
   3. Other factors compensate in part for the variations in the value of money.
   4. There is no agreement as to the method of measuring the effect of the variation in the value of the dollar.
   5. No agreement has been reached as to the manner of disclosing these effects in financial statements.
   6. The comparability of financial statements would be destroyed if some companies adjusted for price level changes while others adhered to cost.
   7. Revaluations are based upon individual judgments or estimates whereas cost is subject to verification.
   8. Repeated adjustments would be required to give recognition to the continuous fluctuation of the revaluation data.
   9. The complexity of the revaluation adjustments would confuse many readers of the financial statements.

Solution 6

a. For accounting purposes a purchase may be defined as a business combination of two or more corporations in which an important part of ownership interests in the acquired corporation or corporations is eliminated or in which other factors requisite to a pooling of interests are not present.

   A pooling of interests may be defined as a business combination of two or more corporations in which the stockholders of substantially all of the ownership interests in the constituent corporations become the owners of a single corporation which owns the assets and businesses of the constituent corporations and in which certain of the following factors are also present:
   1. It is the intention of the parties to merge.
   2. The ownership of the surviving entity is substantially in proportion to the respective interests of the owner of the predecessor corporations.
   3. The merger is supported by business reasons.
   4. The activities of the enterprises being merged are similar or complementary.
   5. There is continuity of management or the power to control management.

b. In the case of a purchase, the assets acquired are recorded on the books of the acquiring corporation at cost. Where the consideration is other than money, cost will be measured by the fair value of such other consideration or the fair value of the property acquired, whichever is more clearly evidenced.

In a pooling of interests the carrying amount of the assets of the constituent corporations and the combined retained earnings and/or deficits are carried forward with only such adjustments as are necessary to state the accounts in accordance with generally accepted accounting principles.

c.	(1) Current assets	$ 500,000	
	Fixed assets	4,000,000	
	Current liabilities		$ 300,000
	Long term debt		1,000,000
	Retained earnings		2,200,000
	Capital stock		1,000,000
	To record exchange of 100,000 shares of Wesco stock for net assets of Southco Corporation.		
	(2) Current assets	25,000	
	Fixed assets	200,000	
	Goodwill	100,000	
	Current liabilities		20,000
	Long term debt		105,000
	Capital stock		50,000
	Paid in capital		150,000
	To record exchange of 5,000 shares of Wesco stock for net assets of Eastco Corporation.		

Solution 7

a. A stock right is the privilege attached to a share of capital stock outstanding to buy a certain number of shares (or a fractional share) of new capital stock. The receipt of stock rights may be compared to the receipt of a stock dividend. In either case, the stockholder does not receive a distribution of assets. Although the investment amount does not change dollar-wise, the investment now is comprised of the share originally acquired and rights which have an independent value because they offer the privilege of acquiring shares at less than market price. Since shares and rights have value, allocation of the cost of the investment is made to the shares and rights on the basis of their relative market values as of the date the rights are issued.

The assigned cost of the stock rights may be charged to a suspense account and credited to the investment account by the investor awaiting action to be taken on the rights. If the rights are exercised the balance in the suspense account is transferred to the investment account. The cost of the new shares consists of the cost assigned to the rights plus the cash that is paid in the exercise of the rights.

If the rights are sold, the difference between the cash received and cost assigned to the rights is recognized as a gain or loss on sale of rights. The suspense account is closed. The investment account remains reduced because the shareholder's equity in the company has been diluted.

If the rights are allowed to lapse, the balance in the suspense account is recognized as a loss since the rights had value. The investment account remains reduced because the shareholder's equity in the company has been diluted. However, when the market price of the stock falls below the subscription price making the exercise of the rights unattractive and the rights cannot be sold before expiration, the balance in the suspense account should be returned to the investment account in case there had been no dilution of the investment. If there had been dilution before the fall in market price, the rights had value and a loss should be recognized.

b.

Market value of 4 shares of stock	$480
Subscription price per share	100
Value of block of 5 shares of stock, assuming exercise of subscription rights	$580
Market value per share, rights-on	$120
Adjusted value per share	116
Theoretical value of each right	$ 4

Solution 8

a. Donated treasury stock implies a corporation's own shares of fully paid and nonassessable shares were given to the corporation. When the shares of its own stock were donated to a corporation they may be recorded by:
(a) merely making a memorandum entry of the number of shares, or
(b) a formal entry debiting Treasury Stock or Donated Stock and crediting a paid-in capital account at the par value or stated value or fair market value of the stock, depending on the circumstances.

Upon subsequent sale of the donated shares:
(a) if a memorandum entry had been made, an entry debiting Cash and crediting a paid-in capital account would be made for the proceeds.
(b) if a formal entry had been made the sale would be accorded treatment in the accounts which when combined with the entries at the time of donation would reflect a net credit to a paid-in capital account equal to the proceeds.

In either case the final results will be the same.

The memorandum treatment is generally considered preferable since there was no cost of the stock to the corporation.

b. (a) Assets and stockholder equity accounts should reflect fair market values at the date of acquisition. Equal values are exchanged for equal values in most economic transactions.

Evidence of overvaluation in the accounts in this instance could be inferred from the briefness of the period between the issuance and donation and the fair market value of the donated stock at the time it was sold.

The donated stock was sold immediately after its receipt. The fair market value was $1.50 per share. In reality, 2,000,000 shares of stock were issued for the mineral properties. Therefore, the carrying value of these properties should be $3,000,000. Since 5,000,000 shares of stock are outstanding, the carrying value should be $7,500,000.

(b) In order to adjust mineral properties and stockholder equity accounts to fair market values as at acquisition and issue dates the adjustment should be:

Paid-in capital	$7,000,000	
Mineral properties		$7,000,000

Solution 9

a. The employer involved here may have elected (a) to fund the entire cost of past service benefits at the time of the adopting of the plan, or (b) to fund such benefits at a faster rate than the rate at which past service costs are being amortized. Pursuant to general practice this cost should be charged to the income of the current and future periods. Though the payment to the fund may have been effected in a single year, the charge to an income account will be on an attenuated basis — hence, during the period that intervenes between the funding and the charge to income, the cost is being carried as a deferred charge.

b. Generally the accumulated past service liability at the inception of the plan may not, at that time, be charged in bulk to earnings nor to retained earnings. However, an appropriation of earnings (to earmark a portion of such earnings and to avoid its payment as a dividend) might be deemed desirable. Inasmuch as the eventual funding and deduction of the past service cost should ultimately give rise to a commensurate income tax saving, only the net amount (i.e., the past service cost minus the tax saving) need be reserved from retained earnings. Of course, as the past service cost is charged to annual income, the appropriation of retained earnings is returned to retained earnings.

c. The present cost of pensions generally involves three factors, which might be stated separately, as follows:

Current service cost — the cost related to the benefits being provided for eligible participants predicated on the services they are then rendering to the employer.

Past service cost — the cost being reflected in the current income statement which is related to services rendered by the eligible employees prior to the adoption of the plan. The amount here referred to is presumably the amount to be deducted currently under acceptable practice which suggests that past service costs are chargeable to operations of the current and future periods benefited.

Trustee's fees — the cost of administering the plan.

Answers to Examinations, May 1961

ACCOUNTING PRACTICE—PART I

May 17 1961; 1:30 to 6:00 p.m.

Solution 1

PART A

Item No.	Ans.
1.	U
2.	W
3.	E
4.	K
5.	A
6.	X
7.	Q
8.	E
9.	L
10.	Z
11.	B
12.	T
13.	S
14.	R

PART B

Item No.	Ans.
15.	C
16.	A

PART C

Item No.	Ans.
17.	A
18.	B
19.	A
20.	C
21.	C
22.	A
23.	D
24.	B
25.	A

PART D

Item No.	Yes	No
26.	X	
27.		X
28.	X	
29.		X
30.		X
31.		X
32.	X	
33.	X	

Solution 2

a. **Distributors, Inc.**

RECONCILIATION OF RECEIPTS, DISBURSEMENTS AND BANK ACCOUNT

For the Month of December 1960

	11/30/60 Beginning Reconciliation	*Receipts*	*Disbursements*	*12/31/60 Ending Reconciliation*
Balance per bank statement	$185,700	$1,350,450	$1,342,476	$193,674
Deposit in transit:				
Collections, 12/31/60		32,110		32,110
Application of 80% of collections included in deposit in transit (recorded as cash disbursements on books)			25,688	(25,688)
Outstanding checks:				
Beginning, 11/30/60	(63,524)		(63,524)	
Ending, 12/31/60			75,046	(75,046)
Total dishonored checks returned during the month		(6,250)	(6,250)	
Check of ABC Co. charged in error			(2,323)	2,323
Collection of accounts receivable deposited but 80% not shown by bank		960,000	960,000	
Adjusted bank balance	$122,176	$2,336,310	$2,331,113	$127,373
Balance per books	$154,826	$2,335,445	$2,322,673	$167,598
Sales reports in transit:				
Beginning, 11/30/60	(32,400)	32,400		
Ending, 12/31/60		(33,800)		(33,800)
Dishonored checks:				
Returned 11/30/60; recorded on books in December	(250)	250		
Returned 12/31/60; recorded on books in January			2,300	(2,300)
Proceeds of Able Co. note		2,015		2,015
Interest expense charged by bank but not recorded on books			6,140	(6,140)
Adjusted book balance	$122,176	$2,336,310	$2,331,113	$127,373

b. **Distributors, Inc.**

ADJUSTING JOURNAL ENTRIES

(1)

		Debit	*Credit*
Loans payable		$33,800	
Cash in bank			$33,800
To adjust cash at year end for 80% of sales of 12/31/60 which was recorded as cash by the company but not recorded by bank until subsequent to 12/31/60.			
Sales 12/31/60	$42,250		
	80%		
Proceeds from sales	$33,800		

(2)

	Debit	*Credit*
Interest expense	6,140	
Cash in bank		6,140
To record interest expense on bank loan.		

(3)

	Debit	*Credit*
Cash in bank	2,015	
Collection expense	5	
Notes receivable		2,000
Interest income		20
To record proceeds from collection of note.		

(4)

	Debit	*Credit*
Accounts receivable	2,300	
Cash in bank		2,300
To record checks dishonored as at 12/31/60.		

Solution 3

ADJUSTING JOURNAL ENTRY

Bad debts recovered	$ 600	
Provision for bad accounts	7,100	
Allowance for bad accounts		$7,700

To establish Allowance for Bad Accounts at December 31, 1960. Bad Debts Recovered is eliminated from income because recoveries of bad accounts are properly restored to the Allowance for Bad Accounts.

Supporting Computations

The provision for bad accounts for 1960 should be based on the experience for the years 1956 to 1958 inclusive, since complete data for those three years are now available.

Year	*Charge Sales*	*Bad Accounts*	*Less: Recoveries*	*Net Bad Accounts*	*% of Sales*
1956	$100,000	$ 2,550	$ 100	$ 2,450	2.45%
1957	250,000	6,200	400	5,800	2.32
1958	300,000	8,500	500	8,000	2.67
Total	$650,000	$17,250	$1,000	$16,250	2.50%

The allowance for bad accounts is computed as follows:

Sales for 1959		$325,000
Sales for 1960		275,000
Total		$600,000
Estimated bad accounts (2.50%)		$ 15,000
Less:		
Already charged off:		
1959 accounts	$6,500	
1960 accounts	1,400	
	7,900	
Less: Recoveries	600	7,300
Amount required		$ 7,700

Solution 4

X Company

WORKSHEET FOR STATEMENT OF SOURCE AND APPLICATION OF FUNDS

For the Year Ended December 31, 1960

	NET CHANGES		*ADJUSTMENTS*				*FUNDS*	
	Debit	*Credit*		*Debit*		*Credit*	*Applied*	*Sources*
Investments		$25,000	(3)	$ 25,000				
Land	$ 3,200						$ 3,200	
Building	35,000		(4)	45,000			80,000	
Machinery	6,000				(5)	$ 6,000		
Office equipment		1,500	(6)	1,500				
Allowance for depreciation								
Buildings		2,000	(9)	6,500	(4)	4,500		
Machinery		900	(9)	5,900	(5)	5,000		
Office equipment	600		(9)	900	(6)	1,500		
Discount on bonds	2,000				(10)	2,000		
Bonds payable		40,000	(10)	40,000				
Capital stock—preferred	10,000				(7)	10,000		
Capital stock—common		12,400	(2)	2,400				
			(8)	10,000				
Premium on common stock		5,600	(2)	600				
			(8)	5,000				
Retained earnings		6,800	(3)	2,500	(1)	18,000		$ 29,300
			(4)	9,500	(2)	3,000		
					(7)	200		
					(9)	13,300		
Working capital	37,400						37,400	
	$94,200	$94,200						
Funds applied to:								
Cash dividend			(1)	18,000			18,000	
Purchase of preferred stock			(7)	10,200			10,200	
Purchase of machinery			(5)	11,000			11,000	
Funds provided by:								
Sale of investments					(3)	27,500		27,500
Sale of building					(4)	50,000		50,000
Sale of common stock					(8)	15,000		15,000
Sale of bonds					(10)	38,000		38,000
				$194,000		$194,000	$159,800	$159,800

X Company

STATEMENT OF APPLICATION OF FUNDS
For Year Ended December 31, 1960

Funds were provided by:		
Operations:		
Net income	$16,000	
Depreciation	13,300	$ 29,300
Sale of assets:		
Investments	27,500	
Building	50,000	77,500
Sale of bonds		38,000
Sale of common stock		15,000
Total funds provided		159,800
Funds were applied to:		
Purchase of assets:		
Land	3,200	
Buildings	80,000	
Machinery	11,000	94,200
Retirement of preferred stock		10,200
Payment of cash dividend		18,000
Total funds applied		122,400
Increase in working capital		$ 37,400

Solution 5

a. Value of inventory lost.

Sales	$150,000
Less gross profit (30%)	45,000
Cost of goods sold	105,000
Add finished goods, May 31	60,000
Goods available	165,000
Less finished goods, January 1	70,000
Goods manufactured and completed	$ 95,000
Raw materials, January 1	$ 15,000
Purchases	50,000
Freight-in	5,000
Total available	70,000
Raw materials, May 31	30,000
Materials used	40,000
Labor	40,000
Overhead	20,000
Work-in-process, January 1	50,000
Cost of production	150,000
Less cost of goods completed	95,000
Work-in-process, May 31—inventory lost	$ 55,000

Computation of Gross Profit Percentage

$$\frac{\text{1955-59 Gross profit}}{\text{1955-59 Sales}} = \frac{\$\ 444{,}000}{\$1{,}480{,}000} = 30\%$$

b.

1. Loss on building and machinery.

	Building	*Machinery and Equipment*
Cost	$ 40,000	$ 15,000
Allowance for depreciation	24,667	4,375
Book value	$ 15,333	$ 10,625
Replacement cost, new	$ 80,000	$ 37,500
Allowance for depreciation—62.5%	50,000	
33.3%		12,500
Present value	$ 30,000	$ 25,000
Insurable value	$ 75,000	
80% coinsurance	$ 60,000	
Insurance carried	$ 65,000	
Sufficient insurance is carried; therefore the loss of the building, and machinery and equipment is collectible in full.		$ 55,000

2. Recoverable loss on inventories.

Raw materials	$ 30,000	
Finished goods	60,000	
Supplies	5,000	
Work-in-process	55,000	
Total insurable amount of inventories	$150,000	
Coinsurance requirement—80% of $150,000	$120,000	
Total insurance carried	$108,000	
Share of loss to be borne by insurance companies: 108,000/120,000 × $55,000 =		49,500
Total expected recovery from insurance companies		$104,500

3. Recovery from individual insurance companies.

	Company A	*Company B*	*Company C*	*Total*
Prorated loss on building, machinery and equipment				
30,000/65,000 × $55,000	$25,385			
20,000/65,000 × $55,000		$16,923		
15,000/65,000 × $55,000			$12,692	$ 55,000
Prorated loss on inventories				
38,000/108,000 × $49,500	17,416			
35,000/108,000 × $49,500		16,042	16,042	49,500
Totals	$42,801	$32,965	$28,734	$104,500

ACCOUNTING PRACTICE—PART II

May 18, 1961; 1:30 to 6:00 p.m.

Solution 1

a. Cash	$ 25,000	
Accumulated depreciation	7,200	
Mortgage notes receivable	125,000	
Plant property		$100,000
Gain on sale of property		9,533
Deferred income		47,667
To record sale of business property.		

Computation of Net Book Value of Property

Purchase price	$100,000
Less appraised value of land	10,000
Remainder—value of building subject to depreciation	90,000
Deduct—depreciation—50 year life is equivalent to 2% per annum	
6/30/56 to 12/31/56 — 1%	
Year 1957 — 2%	
Year 1958 — 2%	
Year 1959 — 2%	
1/1/60 to 6/30/60 — 1%	
Total — 8% × 90,000 =	7,200
Remainder—net book value of building	82,800
Add—appraised value of land	10,000
Total book value of property at 6/30/60	$ 92,800

Computation of Gain and Deferred Income

Sales price	$150,000
Less book value of property	92,800
Total profit on sale	57,200
Deduct—gain on sale applicable to year 1960	9,533
Remainder—deferred income	$ 47,667

Computation of Gain to Be Recorded Upon Collection

Date Payment Received	*Annual Collection*	*Ratio of Annual Collection to Total Sales Price*	*Gain Realized*
6/30/60	$ 25,000	1/6	$ 9,533
6/30/61	30,000	1/5	11,440
6/30/62	30,000	1/5	11,440
6/30/63	50,000	1/3	19,067
6/30/64	15,000	1/10	5,720
Totals	$150,000		$57,200

b. Entries upon collection of notes at their maturities:

June 30, 1961 and June 30, 1962:

Cash	$30,000	
Deferred income	11,440	
Mortgage notes receivable		$30,000
Gain on sale of property		11,440

To record collection of note receivable.

June 30, 1963:

Cash	50,000	
Deferred income	19,067	
Mortgage notes receivable		50,000
Gain on sale of property		19,067

To record collection of note receivable

June 30, 1964:

Cash	15,000	
Deferred income	5,720	
Mortgage notes receivable		15,000
Gain on sale of property		5,720

To record collection of note receivable

c. The Mortgage Note Receivable due on June 30, 1961 would be included in Current Assets.

The other Notes Receivable due on 6/30/62, 6/30/63 and 6/30/64 would be shown in Other Receivables or as a separate item—in either case below the Current Asset section.

The Deferred Income would be shown as a separate item on the liability side below the Current Liability section.

Solution 2

A Manufacturing Company

STATEMENT OF INCOME AND RETAINED EARNINGS

For the Year Ended December 31, 1960

Sales			$2,000,000
Cost of sales			1,100,000
Gross profit on sales			900,000
Operating expenses			400,000
Net income before income taxes			500,000
Liability for federal income taxes		$230,100	
Add: Income taxes to be paid in future due to excess of amortization of defense facility over normally allowable depreciation	$23,400		
Income taxes applicable to nonrecurring loss	26,000	49,400	
		279,500	
Deduct: Income taxes applicable to nonrecurring gain		25,000	
Provision for federal income taxes			254,500
Net income			245,500
Add: Retained earnings, January 1, 1960			800,000
			1,045,500
Add: Gain on sale of plant		100,000	
Less income taxes applicable		25,000	75,000
			1,120,500
Deduct: Uninsured loss of machinery		50,000	
Less income taxes applicable		26,000	
			24,000
			1,096,500
Dividends paid			80,000
Retained earnings, December 31, 1960			$1,016,500

A Manufacturing Company
COMPUTATION OF INCOME TAX LIABILITY
For the Year Ended December 31, 1960

Income			
Sales		$2,000,000	
Less cost of sales			
Per books	$1,100,000		
Exclude depreciation on defense facility	15,000		
	1,085,000		
Add 60-month amortization on facility	60,000	1,145,000	
		855,000	
Expenses and allowable losses			
Operating expenses	400,000		
Casualty loss on machinery	50,000	450,000	
Taxable income before capital gain		$ 405,000	
Tax thereon			
52% × $405,000	210,600		
less	5,500		$205,100
Gain on sale of warehouse		$ 100,000	
Tax thereon			
25% × $100,000			25,000
Total liability for 1960 income taxes			$230,100

Solution 3

a. Investment in XYZ Corporation		$1,800,000	
Cash			$ 550,000
Capital stock			500,000
Paid-in capital in excess of par value			750,000

To record the investment in the capital stock of XYZ Corporation.

The investment is recorded in the amount of the market value of the ABC stock and cash exchanged for the XYZ stock.

b. Cash		390,000	
Accounts receivable		355,000	
Inventories		260,000	
Property B	$450,000		
Property C	600,000		
Property D	150,000	1,200,000	
Investment in XYZ Corporation			1,800,000
Allowance for depreciation—			
Property B	22,500		
Property C	30,000		
Property D	7,500		60,000
Accounts payable			250,000
Retained earnings			95,000

To record the assets and liabilities of XYZ Corporation on the books of ABC Corporation upon dissolution of XYZ.

Computations supporting the above entry are as follows:

(1) It may be presumed that the accounts receivable and accounts payable will be settled for the amounts at which they are carried on the books of XYZ. The value of the inventories would be their replacement cost which in this case was equivalent to the amount at which the inventories were carried on the books of XYZ. The value of property A was established by its sales price. Since no value may be ascribed to goodwill, the remainder of ABC's cost in the stock of XYZ must be applicable to properties B, C and D and should be allocated to those properties in the ratio of their appraised values. Thus, the allocation of ABC's cost should be made as follows:

Cost		$1,800,000
Less amount applicable to the following accounts at June 30, 1960:		
Cash	$ 120,000	
Accounts receivable	240,000	
Inventories	210,000	
Property A	500,000	
Accounts payable	(470,000)	600,000
Balance to be allocated to properties B, C and D		$1,200,000

Allocation to properties:

	Appraised Value		*Cost*
	Amount	*Per Cent*	*Allocated*
Property B	$ 600,000	37.5	$ 450,000
Property C	800,000	50.0	600,000
Property D	200,000	12.5	150,000
	$1,600,000	100.0	$1,200,000

(2) Depreciation recorded by XYZ Corporation for the six months ended December 31, 1960, should be adjusted to record depreciation computed on the basis of ABC's cost in the properties as determined in (1) above. The depreciation thus computed would become the allowance applicable to the properties brought onto the books of ABC Corporation. The determination would be as follows:

Property	*Cost to ABC Corp.*	*Depreciation for Six Months at 10% Rate*	*Depreciation Recorded by XYZ Corp.*	*Difference*
B	$ 450,000	$22,500	$18,500	$ 4,000
C	600,000	30,000	24,000	6,000
D	150,000	7,500	12,500	(5,000)
	$1,200,000	$60,000	$55,000	$ 5,000

(3) The net income of XYZ Corporation for the six months ended December 31, 1960, should be recorded as retained earnings on the books of ABC after making the following adjustments to account for ABC's cost in the properties of XYZ:

XYZ Corporation's net income for six months ended December 31, 1960	$ 450,000
Less	
Depreciation adjustment per (2) above	(5,000)
Elimination of gain on sale of property A	(350,000)
Net income as adjusted	$ 95,000

Solution 4

Adjusting Entries
(Not required)

(1)

Insurance expense	$ 360	
Prepaid insurance		$ 360

To adjust unexpired insurance to $1,000.

(2)

Interest	500	
Accrued interest payable		500

To accrue interest due ABC Life Insurance Company.

(3)

Taxes	300	
Accrued taxes payable		300

To accrue real estate taxes payable.

(4)

Supplies inventory	370	
Advertising and supplies		370

To record supplies inventory.

Dissolution Entries

(a)

Catron, Capital	315	
Johnson, Capital	315	
Cash		630

To distribute cash.

(b)

Johnson, Capital	$ 235	
Catron, Capital		$ 235

Payment to Johnson for petty cash and supplies inventory.

(c)

Land	13,000	
Allowance for depreciation—building	15,000	
Allowance for depreciation—furniture and fixtures	10,800	
Building	3,000	
Furniture and fixtures		11,800
Catron, Capital		15,000
Johnson, Capital		15,000

To record assets at appraised value.

(d)

Johnson, Capital	30,000	
Mortgage payable—Johnson		30,000

To record mortgage payable to Johnson.

(e)

Catron, Capital	1,325	
Johnson, Capital	1,325	
Payoff penalty due ABC		2,650

To record payoff penalty due ABC Life Insurance Company.

(f)

Mortgage payable—ABC Life Insurance Company	53,000	
Interest payable	500	
Payoff penalty due ABC Life Insurance Company	2,650	
Financing cost	625	
Johnson, Capital	27,725	
Mortgage payable, Bank		84,000
Catron, Capital		500

To record mortgage payable to bank and satisfaction of mortgage and other charges payable to ABC Life Insurance Company per disbursement statement.

(g)

Goodwill	14,600	
Johnson, Capital		14,600

To establish goodwill as determined by the balance in the capital account of the retiring partner.

Southern Star Motel

WORKSHEET FOR PARTNERSHIP DISSOLUTION

	Trial Balance March 31, 1961 Debit	*Trial Balance March 31, 1961* Credit	*Adjusting Entries March 31, 1961* Debit	*Adjusting Entries March 31, 1961* Credit	*Income Statement 3 Mos. Ended March 31, 1961* Debit	*Income Statement 3 Mos. Ended March 31, 1961* Credit	*Balance Sheet March 31, 1961* Debit	*Balance Sheet March 31, 1961* Credit	*Dissolution Entries April 1, 1961* Debit	*Dissolution Entries April 1, 1961* Credit	*Catron's Books April 1, 1961* Debit	*Catron's Books April 1, 1961* Credit
Cash	$ 630						$ 630			a $ 630		
Petty cash	100						100				$ 100	
Prepaid insurance	1,360			(1) $ 360			1,000				1,000	
Land	32,500						32,500		c $ 13,000		45,500	
Building	75,000						75,000		c 3,000		78,000	
Allow. for depreciation—building		$ 15,000						$ 15,000	c 15,000			
Furniture & fixtures	30,000						30,000			c 11,800	18,200	
Allow. for depreciation—furniture & fixtures		10,800						10,800	c 10,800			
Mortgage payable—ABC Life Insurance Company		53,000						53,000	f 53,000			
Catron, Capital		28,265						28,265	a 315	b 235		$ 44,095
								A 1,735	e 1,325	c 15,000		
										f 500		
Johnson, Capital		28,265						28,265	a 315	c 15,000		
								A 1,735	b 235	g 14,600		
									d 30,000			
									e 1,325			
									f 27,725			
Room income		17,249				$17,249						
Wages	3,545				$ 3,545							
Advertising and supplies	2,755			(4) 370	2,385							
Repairs and utilities	2,234				2,234							
Office expense	114				114							
Taxes	166		(3) $300		466							
Depreciation	3,770				3,770							
Interest	405		(2) 500		905							
	$152,579	$152,579										
Insurance expense			(1) 360		360							
Accrued interest payable				(2) 500				500	f 500			
Accrued taxes payable				(3) 300				300				300
Supplies inventory			(4) 370				370				370	
			1,530	1,530	13,779	17,249						
Catron—Profit					A 1,735							
Johnson—Profit					A 1,735							
					$17,249	$17,249	$139,600	$139,600				
Mortgage payable—Johnson										d 30,000		30,000
Payoff penalty due ABC Life Insurance Company									f 2,650	e 2,650		
Financing cost									f 625		625	
Mortgage payable—Bank										f 84,000		84,000
Goodwill									g 14,600		14,600	
									$174,415	$174,415	$158,395	$158,395

(A) Carried forward to Balance Sheet columns.

Solution 5

EXPLANATION OF DIFFERENCE BETWEEN ACTUAL COSTS AND STANDARD COSTS

		Variance			
		Quantity		*Price*	
		Over	*Under*	*Over*	*Under*
Raw materials					
Actual quantity	13,000 lbs.				
Standard quantity	12,600 lbs.				
Excess at standard $.45	400 lbs.	$180.00			
Actual price	47¢				
Standard price	45¢				
Excess at standard 12,600 lbs.	2¢			$252.00	
Excess quantity, 400 lbs., at excess price, 2¢				8.00	
Totals		$180.00		$260.00	
Summary:					
Variance due to excess quantity at standard price					$180.00
Variance due to excess price for standard quantity					252.00
Variance due to excess price and excess quantity					8.00
					$440.00
Actual cost of raw materials					$6,110.00
Standard cost of raw materials					5,670.00
Increase in cost of raw materials					$ 440.00
Direct labor					
Actual hours	7,920				
Standard hours	7,560				
Excess at standard $2.15	360	$774.00			
Standard price	$2.15				
Actual price	2.12				
Deficiency at standard hours 7,560	$0.03				$ 226.80
Excess hours, 360, at deficiency of price 3¢					10.80
		$774.00			$237.60

Summary:

Variance due to excess hours at standard rate		$774.00
Less:		
Variance due to standard hours at deficiency rate	$226.80	
Variance due to excess hours at deficiency rate	10.80	237.60
Total direct labor variance		$536.40
Actual direct labor costs		$16,790.40
Standard direct labor cost		16,254.00
Increase in direct labor costs		$ 536.40

		Variance	
		Over	*Under*
Overhead			
Efficiency			
Actual hours	7,920		
Standard hours	7,560		
Excess at standard $2.75	360	$ 990.00	
Capacity			
Planned hours	8,640		
Actual hours	7,920		
Excess at standard rate $2.75	720	1,980.00	
Budget			
Planned	$23,760		
Actual	20,592		$3,168.00
		$2,970.00	$3,168.00

Summary:

Variance due to inefficiency	$ 990.00
Variance due to unutilized capacity	1,980.00
	2,970.00
Less: Budget savings	3,168.00
Total overhead variance	$ 198.00
Standard overhead for actual output	$20,790.00
Actual overhead	20,592.00
Reduction in overhead	$ 198.00

Solution 6

X County
GENERAL FUND WORKSHEET
For the Year Ended December 31, 1960

	Trial Balance January 1, 1960		*Transactions for the Year* Debit	*Transactions for the Year* Credit	*Variances from Budget* Debit	*Variances from Budget* Credit	*Balance Sheet December 31, 1960*	
Cash in savings accounts	$ 60,650		(2) $ 1,050	(6) $ 25,000			$36,700	
Cash in checking accounts	41,380		(4) 2,225	(2) 28,700			39,845	
			(6) 25,000	(5) 60				
Cash on hand	320		(5) 60				380	
Inventory of jail supplies	3,070		(3) 2,050				5,120	
Due from towns and state for board of prisoners	3,550			(4) 2,225			1,325	
General fund surplus		$108,970	(1) 28,000					$80,970
	$108,970	$108,970						
Revenues:								
Town taxes			(1) 20,000	(2) 20,000				
Unincorporated business tax			(1) 18,000	(2) 18,070		$ 70		
Board of prisoners			(1) 5,000	(2) 4,550	$ 450			
Interest on savings accounts			(1) 1,000	(2) 1,050		50		
						120		
Unrealized revenues						330		
					$ 450	$ 450		
Appropriations and expenditures:								
Jail operating costs			(2) 55,230	(1) 55,500		$2,320		
				(3) 2,050*				
Court operating costs			(2) 7,110	(1) 7,500		390		
Commissioners' expenses			(2) 6,670	(1) 8,000		1,330		
Miscellaneous expenses			(2) 2,310	(1) 1,000	$1,310			
			$173,705	$173,705				
					1,310			
Unexpended appropriations					2,730			
					$4,040	$4,040		
Budget in excess of expenditures					$2,730			
Budget in excess of revenues					330			
					$2,400			2,400
							$83,370	$83,370

*It is equally correct to credit this amount to General Fund Surplus since no information is given as to whether appropriation expenditures are to be based on purchases or consumption.

AUDITING

May 18, 1961; 8:30 a.m. to 12:00 m.

Solution 1

a. Frequently, the auditor is aware that confirmation requests may not be completed when the client's accounts receivable include certain types of customers such as government agencies, companies with decentralized accounts payable departments, or companies using the voucher system. In these cases he may wish to begin alternative procedures before replies are received.

The alternative procedures are essentially the extension and intensification of procedures which would have been followed if the response to the confirmations had been satisfactory. The objectives of such procedures are to satisfy the auditor of the quality of the internal control over receivables and of the genuineness and accuracy of the receivables figures.

1. The best alternative procedure is proof of subsequent collection obtained by:
   (a) Actual examination of incoming checks and remittance advices.
   (b) Later tracing such evidence to deposit slips, cash receipts book and accounts receivable ledger.
   (c) Verifying subsequent postings in the accounts receivable ledger by tracing to source documents.
2. In the absence of proof of subsequent collection, the auditor should satisfy himself by examination of pertinent documents or other evidence such as:
   (a) Contracts and sales agreements.
   (b) Shipping records.
   (c) Sales returns and allowances.
   (d) Correspondence files.
   (e) Copies of sales invoices.

b. The second sentence of the scope paragraph of the independent auditor's report should contain a statement as to the inability to confirm certain receivables. Such a sentence might read as follows:

"Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances; however, it was not practicable to confirm receivables (United States Government receivables), as to which we have satisfied ourselves by means of other auditing procedures."

If the amount of such receivables is material, the amount and percentage of total receivables might be mentioned in the scope paragraph. Another means of showing the materiality might be the separation of United States Government receivables and other receivables on the balance sheet.

If the auditor is satisfied as to the validity, amount and presentation of receivables, no exception would be required in the opinion section of the report.

Solution 2

a. *Necessary adjustment to client's physical inventory*:

Material in Car #AR38162 — received in warehouse on January 2, 1961	$ 8,120
Materials stranded en route (Sales price $19,270 ÷ 125%)	15,416
Total	23,536
Less unsalable inventory	1,250*
Total adjustment	$22,286

b. *Auditor's worksheet adjusting entries*:

1. Purchases	$ 2,183	
Accounts payable		$ 2,183
To record goods in warehouse but not invoiced — received on RR 1060.		
2. No entry required. Title to goods had passed.		
3. Accounts receivable	12,700	
Sales		12,700
To record goods as sold which were loaded on December 31 and not inventoried — SI 968.		
4. Sales	19,270	
Accounts receivable		19,270
To reverse out of sales, material included in both sales (SI 966) and in physical inventory (after adjustment).		
5. Sales	15,773	
Accounts receivable		15,773
To reverse out of sales, invoices #969, 970, 971. The sales book was held open too long. This merchandise was in warehouse at time of physical count and so included therein.		
6. Claims receivable	1,600	
Purchases		1,250
Freight in		350
To record claim against carrier for merchandise damaged in transit.		

*If freight charges have been included in the client's inventory, the amount would be $1,600 and the amount of the total adjustment would be $21,936. Journal entry 6 probably would have a credit to purchases of $1,600 in this case.

7. Inventory	$22,286	
Cost of goods sold		$22,286
To adjust accounts for changes in physical inventory quantities.		

Solution 3

a. Under any of the following conditions, the principal auditor would be justified in accepting full responsibility for the work of another auditor:
   1. After inquiry as to his professional standing, the principal auditor engages the other auditor to act as his agent for the engagement.
   2. The other auditor is an affiliated or correspondent firm whose work is accepted by the principal auditor.
   3. The principal auditor has made sufficient review of the other auditor's work to permit its acceptance.
   4. The amounts involved are not material.

b. Under generally accepted rules of professional conduct, the other auditor must be a certified public accountant with professional standing and independence.

   Inquiries as to his professional standing and independence might be directed to national or state societies of certified public accountants, or to his state board of accountancy. Prior to engagement, references could be required from the other auditor. Such references might include bankers, attorneys, or other accounting firms for whom he has performed correspondent audit work.

c. (1) As principal auditor, if you are willing to accept full responsibility for the work of another auditor, then no mention of the other auditor need be made in your report; if you desire, your reliance may be disclosed in the scope paragraph.

   (2) If you are unwilling to accept responsibility for his work, your report's scope and opinion paragraphs should disclose your reliance on another auditor. Moreover, your report should state whether your opinion is qualified or you disclaim the expression of an opinion. The decision regarding your opinion would be based upon the materiality of the amount involved.

Solution 4

a. Internal control has many weaknesses because of the reliance on one person, the branch manager.
   1. Fictitious new employees might be "hired and released" within a short time.
   2. Fictitious part-time or temporary personnel might be placed on the payroll.
   3. A terminated employee might be continued on the payroll for some time before a termination notice is forwarded.
   4. Unclaimed wages might be diverted.
   5. The branch manager might overpay himself by not deducting for unauthorized absences.

   Through the device of changing the payroll figures after the employee's signature has been obtained:
   6. Legitimate salary increases or promotions might be diverted.
   7. Deductions for withholding tax and net pay might be changed.
   8. Hours might be increased and salary recomputed.

b. In addition to the usual payroll audit procedures, the audit program should include special procedures directed to the areas of internal control weaknesses.
   1. Determine by inquiry, scanning of payroll sheets and minutes of the salary committee which offices had high turnover in personnel. Scanning of payroll sheets might reveal alterations of salaries and deductions.
   2. For selected offices, foot a representative number of payrolls.
   3. Check computation of salaries and deductions.
   4. Trace payroll deductions to the branch office's accounting statements.
   5. Trace earnings and deductions to individual payroll records.
   6. Compare signatures on payroll sheets with signatures on W-4 forms or other personnel forms.
   7. Compare questionable signatures with handwriting samples of the branch manager.
   8. Compare payroll sheets and minutes of the salary committee for agreement as to starting dates, terminations, promotions, salary adjustments and transfers.
   9. Compare dates on W-4 forms and other personnel forms with payroll sheets as further indication of correct starting date.
   10. As a further test of the authenticity of employment and termination dates, compare names and dates appearing on state reports of unemployment compensation paid to former employees.
   11. Review reports submitted by the area supervisors for references to personnel.
   12. Consider the relationship of the number of personnel and salary costs in comparison to the business volume.
   13. Prepare negative confirmations to be mailed with W-2 forms. Investigate any unclaimed W-2 forms.
   14. Observe a salary distribution, or, if not possible, include in your field working paper instructions the requirement that the field auditor should list personnel working in the office for subsequent comparison to the payroll records.

Solution 5

a. In addition to the regular cash audit program, the audit procedures are as follows:
   1. Obtain a list, if available, of the checks comprising the $27,600 including check numbers, amounts and dates mailed.
   2. Confirm the bank balance at December 31 and audit the client's bank reconcilement using the usual audit steps in connection with bank and cash reconciliation.
   3. Obtain the cutoff bank statement and cancelled checks directly from the bank.
   4. Scrutinize each check returned by the bank and indicate on the list submitted by the client the date the check was deposited by the creditor and the date the check was charged to the client's account. Those checks deposited by the creditors after January 4 and posted to the client's account after January 5 may be assumed, in the absence of other evidence, to have been unmailed at December 31. Those checks which cleared either the creditor's or client's bank on January 4 were probably mailed on or before December 31.

5. The client should be advised that, if he continues this practice, he should request the auditor to inspect the checks on hand on the last day of the year to substantiate the reversing entry.

b. The outstanding checks said by the client to have been distributed after December 31 should be reversed to the extent that they were actually distributed after that date. That the cash account was overdrawn is not the reason for the reversal. An actual overdraft should be revealed and not eliminated by improper journal entries. The primary purpose of the reversal is to properly "cutoff" the cash and show the proper cash balance. Showing the correct cash balance eliminates "window dressing"; recorded but undistributed checks would distort the current ratio by reducing both cash and accounts payable. Another consideration is that the client's accounting system might be on a cash basis.

Solution 6

a. Opinion:

We have examined the following statements of Jiffy Clerical Services as of December 31, 1960 and for the year then ended:

Statement of assets and liabilities, on a cash basis, adjusted to give effect to the liability for federal income taxes.

Statement of cash receipts and disbursements on account of income and expenses, adjusted to give effect to the provision for federal income taxes payable on the cash basis earnings.

Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Because accounts receivable of $55,000 and accounts payable of $30,000, which are material in amount have not been recognized, the statements do not, in our opinion, present the financial position of the company or the results of operations for the period reviewed.

However, in our opinion, these statements present fairly the assets and liabilities of Jiffy Clerical Services as of December 31, 1960 arising from cash transactions, and income collected and expenses disbursed for the year then ended, both adjusted to give effect to the provision for federal income taxes for the current year, on a basis consistent with that of the preceding year.

b. The certificate must be modified because the statements are not in conformity with the meaning of "generally accepted accounting principles" as used in the conventional short form certificate. No reference is made to generally accepted accounting principles because cash basis statements omitting assets or liabilities of material amount are not in accordance with such principles.

The unrecorded receivables and payables are material in relation to the financial position and must be disclosed. This disclosure is by means of a special middle paragraph in the certificate. Omission of these unrecorded items also requires that we state that the statements do not present the financial position or the results of operations of the company.

Further, the statements are not called balance sheet, statement of financial position or income statement because of material differences from accrual statements. Special care must be taken to avoid leading the reader into incorrect inferences. Cash basis statements should be clearly titled to reveal what they represent and to avoid implying that they present financial position, operating results, or anything beyond that which they should be expected to cover.

Solution 7

Col. No.	*Source*	*Verification*
1.	Note	Note examination and positive confirmation. Trace to general journal entry. Trace to customer's account. Compare total to control account.
2.	Note	Note examination. Trace to customer's account.
3.	Note	Note examination and positive confirmation. Compare with date of entry.
4.	Note	Note examination and positive confirmation.
5.	Note	Note examination and positive confirmation.
6.	Note	Note examination and positive confirmation.
7.	Notes Receivable account	Trace to cash receipts book. Positive confirmation from bank.
8.	Bank memo	Positive confirmation from bank. Trace to cash receipts book.
9.	Bank memo	Trace to cash receipts and Interest Expense account. Computation considering Nos. 7 & 8.
10.	Interest Income account and notation on note.	Trace to cash receipts.
11.	Information from Nos. 3, 5, 6 and 10 is basis for computation.	Trace to adjusting journal entries and ledger accounts.
12.	Interest Income account and notation on note.	Note examination. Trace to cash receipts.
13.	Note	Note examination and positive confirmation. Trace to cash receipts.
14.	Computed, No. 5 minus No. 13	Trace to control account. Positive confirmation.
15.	Management representation confirmations, note or collateral record.	Note examination, positive confirmation, and inspection of collateral.

Solution 8

a. To determine the status of the liability for federal income taxes of prior years:

1. Through inquiry and review of correspondence files determine which years are subject to possible additional assessments resulting from Treasury examinations.
2. Ascertain that those years for which the statute of limitations has expired have not been extended by waiver. Review all tax returns for open years.
3. Inspect revenue agents' reports of recent years, if any, and ascertain that any assessments have been paid or provided for. Determine whether assessments resulting from examination of prior years' returns would give rise to tax deficiencies or refunds in other open years not yet examined.
4. Review claims for refund of prior years' taxes, if any, and evaluate their collectibility.
5. Review the reconciliation of net income per books with taxable income reported in returns for open years and ascertain that reconciling items are in order.
6. Correspond with the prior auditor if any unusual matters are discovered.

b. To determine the propriety of the provision for income tax on the current year's income:

1. Reconcile net income per books with taxable income to be reported in the current year's tax returns and compare with prior year's reconciliation.
2. Determine whether the computation of taxable income requires giving effect to adjustments resulting from treasury examinations of prior years.
3. Review operating and capital losses, if any, for the five preceding years and determine to what extent such losses may be offset against income of the current year.
4. Check client's calculation of federal income tax for the current year.
5. Determine that a declaration of estimated tax has been filed, if required, and proper prepayment thereon has been made.
6. Consider the effect on the tax liability of elections that are available to the client in computing taxable income (accelerated depreciation, consolidated vs. separate returns, deferral of development costs, lifo method for inventories, etc.) and discuss with client.
7. If taxable income is materially less than, or more than, book income due to items which by their nature only defer the payment of taxes to a later year, or, in effect, result in prepayment of taxes which relate to a later year, consideration should be given to providing for such deferral or prepayment.

COMMERCIAL LAW

May 19, 1961; 8:30 a.m. to 12:00 m.

Solution 1

	A	*B*	*C*	*D*	*E*
1.	X				
2.			X		
3.					X
4.					X
5		X			
6.	X		X	X	
7.	X		X	X	
8.		X	X		
9.		X	X	X	
10.			X	X	
11.	X			X	
12.	X		X	X	
13.	X	X	X		
14.				X	
15.			X	X	

Solution 2

	A	*B*	*C*	*D*	*E*
1.	X	X	X	X	
2.	X			X	
3.		X		X	
4.		X		X	
5.	X		X	X	X
6.	X	X		X	X
7.	X	X	X		
8.	X			X	
9.			X		
10.			X	X	
11.	X	X	X		
12.	X			X	X
13.	X		X		
14.	X		X	X	X
15.	X		X	X	

Solution 3

	A	*B*	*C*	*D*	*E*
1.	X	X	X	X	
2.			X	X	
3.		X			
4.	X	X			
5.			X		
6.		X	X	X	
7.	X		X	X	
8.	X				
9.	X	X	X	X	
10.	X	X	X		
11.		X	X	X	
12.	X		X	X	X
13.	X		X		
14.	X	X			
15.	X			X	

Solution 4

	A	*B*	*C*	*D*	*E*
1.	X	X	X		X
2.	X			X	X
3.	X	X			
4.	X		X	X	X
5.	X				
6.	X	X		X	X
7.		X	X	X	X
8.				X	X
9.					X
10.			X		
11.					X
12.		X		X	X
13.	X		X	X	
14.	X		X		
15.	X	X	X	X	

Solution 5

a. 1. Yes, Harold can collect on the negotiable instrument against the Friendly Finance Company.

David was an impostor, that is, one who has induced the maker to issue to him a negotiable instrument payable to the payee, Frank. As such, an impostor can sign the payee's name and pass good title to a holder in due course. But for the impostor rule, the instrument would contain the forged indorsement of the payee which would be a real defense and thus, defeat even the rights of a holder in due course.

2. Friendly Finance Company can sue David for fraud (deceit). The elements of fraud are: (a) misrepresentation of material fact, (b) made with knowledge of falsity, (c) an intent that plaintiff rely, (d) reliance thereon and (e) to the plaintiff's detriment.

b. 1. A transfer for value of order paper without an indorsement vests in the transferee such title as the transferor had and, in addition, gives the transferee the right to have the indorsement of the transferor.

2. X can become a holder in due course only at the time the indorsement is actually made.

Solution 6

a. This is a mutual benefit bailment. The owner has retained title to the property, but has transferred possession to the dry cleaners for the purpose of having work performed at the agreed price.

b. The mutual benefit bailee must exercise reasonable care in respect to the bailor's property.

c. In this bailment situation the bailee rather than the bailor has the burden of showing or explaining what happened to the suit. Normally such burden lies with the party seeking recovery, that is, the plaintiff.

Based solely upon the facts stated the plaintiff should prevail. If no proof is offered as to the disappearance then the case should be decided in plaintiff's favor. In order to state a case the bailor need only show that there has been a bailment, a rightful demand for a return of the property and a failure on defendant's part to return the property.

d. Yes. If defendant can prove that the destruction was not due to any fault on his part, then he will not be liable. The bailee is not an insurer of the property and thus, he will only be liable if he intentionally or negligently caused the destruction of the property.

e. Yes. If the bailor refuses to pay, the bailee has the right to assert a bailee's lien against the property bailed. This is a common type of possessory lien and protects the bailee in such cases.

Solution 7

a. 1. No. The risk of loss was on the buyer. Once the seller, in accordance with the terms of the contract, delivered the goods to the carrier the risk of loss shifted to the buyer. Thus, in the event of destruction or damage to the goods while in transit, the buyer suffers the loss.

2. No. Although a common carrier is an insurer of the property it transports, it is not liable for acts of God. In this case, unless the railroad was otherwise at fault, the damage to the goods was caused by flooding which is considered an act of God.

3. Yes. The common carrier is an insurer of the property it transports and as such, would be liable even though the loss was not caused by its fault. There is an exception in the case of acts by public enemies, e.g., during war or revolution, but armed robbers would not be included within the meaning of the term.

b. 1. Under the Uniform Sales Act, four implied warranties can arise in sales transactions, namely: the warranty of merchantability, the warranty of fitness and the warranties in connection with a sale by sample and by description. The Uniform Commercial Code has changed the last two implied warranties mentioned above to express warranties.

2. None. It is clear that where there has been an inspection, the warranty of merchantability will not apply as to defects which the inspection ought to have revealed. In this case both defects (imperfections in the finish and inability to play on direct current) were readily apparent and, therefore, the buyer cannot recover on the basis of this warranty.

It is clear that the implied warranty of fitness does not arise in that it does not appear that the seller had any knowledge of the intended use of the radios on direct current. In addition, even if such warranty did arise, it is evident that the examination, as in the case of the implied warranty of merchantability, was negated as to defects that were readily apparent. Thus, there can be no recovery on the basis of this warranty.

The warranty that arises in connection with a sale by sample is that the bulk will correspond with the sample. Since the facts clearly indicate that the bulk was in all ways comparable to the sample, there would be no breach of this warranty. Once again, no recovery would be available to the buyer. The result would be the same under the Uniform Commercial Code even though the code changes this particular warranty to an express warranty.

Since there was no description of the product sold indicated in the fact situation the warrant of description is not relevant here.

Solution 8

a. This is a pledge or collateral loan which is defined as a special form of bailment by which one person transfers possession of personal property or a document representing title to the property to another for the purpose of securing the payment of a debt or the performance of an obligation.

b. In order to be valid a pledge or collateral loan is dependent upon possession by the pledgee of the property or a document representing title to the property.

c. No. Upon repayment in full Bill has no right to any profit accrued on the bonds or to any interest payments or matured coupons because title to the colateral was retained by the pledgor (bailor), and pledgee secured no ownership rights through possession of the collateral. Until repayment, however, Bill would have the right to consider any increase in value of the bonds or accrued interest as an addition to his collateral and to retain same for application to the debt if necessary to satisfy it fully.

d. Upon default the creditor could:
   1. Sue on the promissory note given by Andy.
   2. Give reasonable notice of the time and place of sale to the pledgor and sell the pledged chattels at a public sale if they are goods or instruments which have a market.
   3. Maintain an action in a court of equity for foreclosure and sale of the pledged property and, if the pledgor is under a personal obligation, also obtain a deficiency judgment in the event that the proceeds of sale do not satisfy the claim secured by the pledge. Any excess, after satisfaction of the debt and the expense of the sale, will inure to the benefit of the debtor.

THEORY OF ACCOUNTS

May 19, 1961; 1:30 to 5:00 p.m.

Solution 1

	A	B	C	D	E
1.			X		
2.	X			X	
3.		X			
4.		X			
5.		X	X		
6.		X			
7.			X		
8.	X				
9.				X	
10.	X				
11.	X	X	X		
12.	X	X			
13.		X			
14.	X	X	X		
15.			X		
16.		X	X	X	
17.	X	X	X	X	
18.		X			
19.			X	X	
20.					X

Solution 2

a. Frequently a business might operate over a period of time without net earnings and still have a steady increase in cash. This situation could be caused by noncash entries required to match expiring costs with current income. Earnings are reduced by the noncash entries but cash is not disbursed.

b. A review of the financial statements reporting the breakeven operation might reveal any of the following noncash entries:
1. Depreciation of fixed assets.
2. Amortization of deferred charges and intangibles.
3. Reduction in prepaid expenses.
4. Depletion of wasting assets.
5. Provision for valuation reserves through charges to current operations.

c. The following statements might be prepared for the president to account for the increase in cash:
   1. Statement of source and application of funds.
   2. Statement of cash flow.
   3. Statements of income on a comparative basis.
   4. Balance sheet on a comparative basis.

Solution 3

Although it is common practice to charge interest on borrowed money used to finance the construction of fixed assets to interest expense, in this case capitalizing the interest would be justified.

Capitalizing the interest would be consistent with the principle of matching costs with revenues. The revenue would be received after the planes were delivered, therefore the interest cost should be charged to the periods benefited.

Because the interest cost is material in relation to net income, it would distort income if expensed during the conversion period. The interest cost is material also in relation to the cost of the jet planes due to the high interest rates, and should be included in determining the total cost of the new planes.

The interest might be capitalized by adding to the cost of the assets or by establishing a deferred charge to be written off over the life of the assets.

Solution 4

a. The preferred method of accounting for income under the long-term construction-type contracts is the percentage-of-completion method. Income is recognized to be that percentage of estimated total income that incurred costs to date bear to estimated total costs as adjusted by estimated costs to complete the project. Another term for this method is the production basis.

   Another approach would be based upon the percentage of physical completion as estimated by qualified engineers or architects. The percentage would be applied to the contract price to arrive at estimated revenues and the deduction of costs incurred to date would determine current earnings.

   This method is desirable if the estimate of the percentage of completion is reasonably dependable and few projects, each of which is relatively long-term, are undertaken. Income would be highly erratic if not accrued.

   An advantage of the percentage-of-completion method is that it recognizes income in the period in which effort was expended. Another advantage is that it requires reviewing the status of uncompleted contracts by estimating costs to complete the projects.

   Disadvantages of this method are that it depends on the estimates of completion and of total costs and that it accrues income subject to uncertainties inherent in long-term contracts such as contract cancellation, price adjustments, specification changes, etc.

b. The alternative method of accounting for income is the completed contract method. This method recognizes income when the contract is completed or substantially so, which in this case would make reported income highly erratic. Moreover, this method does not measure current performance.

Objections to the completed contract method might be overcome by the preparation of statements for particular projects or statements for a longer period of time. The needs of management and stockholders for statements on at least an annual basis, however, probably precludes the preparation of statements only for a longer period.

Solution 5

a. 1. When a firm guarantees to service a product without additional charge to the buyer, the future service expense should be recognized in the period in which revenue from the sale is recognized. A current liability, such as "Reserve for Service Guarantees," should be established at the time of the sale for the amount of the estimated cost to provide the service.

2. "Reserve for Plant Depreciation" is an offset to the plant account in the fixed asset section. The account shows the portion of the plant cost charged to past operations by periodic allocations of the cost. The net asset (asset less accumulated depreciation) reveals the remaining cost to be assigned to future operations.

3. A "Reserve for Foreign Earnings" is established in the equity section of the balance sheet when unremitted foreign earnings are included in income and their realization in dollars appears doubtful. The purpose of the segregation is to disclose the condition and to limit earnings available for dividends. (Accounting authorities are not in agreement on the procedure of including in current income the unremitted foreign earnings on deposit in a blocked-exchange country.)

4. A "Reserve for Replacement of LIFO Inventory" would arise when a company using the LIFO method failed to maintain its usual minimum inventory position. The failure may have been caused by a supplier's strike, disruption of transportation or delay in placement of purchase orders either through oversight or decision to withhold ordering in anticipation of a price reduction. When there has been a significant price rise in replacement cost, rigid adherence to the LIFO method would mean matching old low costs against revenues from goods sold at current high prices. Therefore, a current liability would be set up as a "Reserve for Replacement of LIFO Inventory" by a charge to "Cost of Goods Sold." The amount would be net of income taxes.

b. The term "reserve" causes confusion when used in financial statements because of the difference between general usage or meaning and accounting usage or meaning. The misinterpretation that a "reserve" is cash or property held for some special purpose is derived from the general meaning of the term. In contrast, "reserve" in accounting terminology has three conflicting meanings: a valuation account, liability of uncertain amount and an appropriation of retained earnings.

To eliminate the conflict of meanings it has been suggested that "reserve" be restricted to accounts reporting segregated or appropriated retained earnings. When so used, the term indicates that an individual or unidentified portion of the net assets, in a stated amount, is being held or retained for a special purpose.

Accordingly, the application is correct when used for "Reserve for Foreign Earnings" which is a segregation of retained earnings.

The term "reserve" should be deleted from the titles of the other accounts since they are valuation or liability accounts. "Estimated Liability for Service Guarantees" is preferred over "Reserve for Service Guarantees." "Reserve for Plant Depreciation" should be replaced by "Allowance for Depreciation — Plant" or "Accumulated Depreciation — Plant." Better terminology for "Reserve for Replacement of LIFO Inventory" is "Excess of Replacement Cost over LIFO Cost of Basic Inventory Temporarily Liquidated."

Solution 6

a. A primary objective of accounting is to determine net income by matching applicable costs and expenses against revenues. To achieve this objective, costs and expenses benefiting future periods should be assigned to those periods. Conversely, the principle of deferment should not be applied to costs and expenses applicable to the current period.

A "conservative" accounting policy entails the application of caution or moderation in decisions regarding accounting procedures. Because of the uncertainty of future profits, a "conservative" policy requires decisions, based on generally accepted accounting principles, which result in smaller current net profits or lower valuation of assets. The president's proposal is not "conservative" because it would result in a greater net profit in the current period and, by establishing a new asset, would cause an increase in total assets.

"Consistency," in accounting terminology, implies the application to one accounting entity the same accounting practices, methods and procedures unchanged from one accounting period to the next. The president's argument that capitalization of the loss would be "consistent" is an incorrect use of the accounting term. The president is not applying "consistency" to the comparison of Willis Corporation's accounting practices for 1959 and 1960 (since this is the company's first branch, there is no policy with which to be consistent); rather, he is misapplying "consistency" to the comparison of Willis Corporation and industry practices.

An accounting practice established in an industry lends considerable credence to its acceptance as a generally accepted principle. Frequently, however, when the practice is reviewed by comparison to general accounting practices, it is found to be improper. The financial statements of a going business should reveal current operating profits or losses. Therefore any practice whereby current operating expenses or losses are deferred to a more profitable period is not in accordance with generally accepted accounting principles. There is no assurance that the branch would ever be profitable.

b. The disclosure to be made in the financial statements would be dependent upon the accounting treatment of the loss. If the operating loss is charged to the current period and clearly set out in the financial statements to reveal its effect upon current operations, adequate disclosure will have been made.

If the loss is capitalized, disclosure should be made by a footnote explaining the capitalization and its effect on the financial statements. Should the footnote be omitted, to provide disclosure an exception should be taken in the opinion paragraph of the auditor's certificate.

Solution 7

a. In assessing the resources available to management in carrying out its intermediate and long-range plans, the current value of readily marketable securities is a significant fact. Present market value is one of the significant indications of potential resources even though there is no present intention (or within one year) of disposing of them. Market value is probably more significant than cost, insofar as estimates of the future are concerned, even though the elapsed time may be three to five years. Current market value puts readers of the statements in a better position to make decisions.

This method also puts the gains and losses from dealing in these investments in the year in which the change in value took place, rather than in the year realized by disposal. Both revenue, in the form of dividends, and gains and losses, in the form of price changes, are thus reported on a current basis. Significant earning rates can be obtained only in this manner.

b. This method is contrary to the generally accepted practice of recording long-term investments on the basis of amounts invested. Gains or losses, not realized by completed transactions, would be reported. Furthermore, because the company has no intention of selling or trading in securities, the pertinent factor is the cost of the securities and not the market value.

c. The preferred method would present these securities at cost in financial statements, with market value indicated parenthetically or by footnote for information disclosure to the readers. However, long-term investments should be reported at market when there is a serious decline in market price and no likelihood of recovery before the investments are realized. To preserve a record of costs, the credit to record the valuation decrease should be made in a contra account rather than in the asset account. Should there be some later recovery in market price, the contra account may be adjusted.

Inasmuch as the investments are not expected to be realized in cash or sold or consumed during the normal operating cycle of the business, they should be excluded from the current asset section, and reported under a noncurrent caption such as "Investments." Consideration should be given to using the balance sheet format of a regulated investment company where there are no side captions for current assets, investments, fixed assets, etc.

Solution 8

a. 1. $1.20
   2. $2.00
   3. $1.80
   4. $2.00
   5. $1.70

b. $1.70

c. (1) Under normal circumstances the cost of freight in would be included in determining inventory values. Should freight costs be excluded from inventory value, there would be little effect on the income statement if the excluded amount did not vary from one fiscal period to the next except for the first year and last year of the life of the economic unit. The exclusion would not be important from a balance sheet standpoint when the freight cost is immaterial. When inventories are valued at the lower of cost or market, the exclusion of freight costs might have no effect because often a value lower than cost would be used.

Exclusion of freight costs would be justified when the costs arose because of inefficiencies. An example would be the movement of excess inventories from one branch to another. Another example would be special handling or rush handling charges when the inventory of certain items was depleted because of inefficient management.

Except where an average method is in use, inventory values under perpetual inventory methods such as FIFO, LIFO, or base stock are usually round amounts (no mills or penny fractions). Addition of a freight cost per unit might upset these values, so as a practical expedient, freight costs might be treated as a period cost.

Where freight costs are relatively small, exclusion might be justified on the grounds of practicability. For example, allocation of freight costs to a shipment of mixed jewelry items would hardly be worthwhile. In contrast the exclusion of freight costs of a combined shipment of coal and coke would not be condoned because freight is material in relation to the value of the goods. When the expense or difficulty of making an allocation is greater than the accounting benefit derived because of the relative immateriality of the amount, the freight should be treated as a period cost.

(2) Other costs which might be similarly excluded are:

a. Insurance in transit.

b. Duties and custom charges.

c. Receiving costs.

d. Inspection costs.

e. Purchasing department costs.

f. Storage.

g. Demurrage.

Answers to Examinations, November 1961

ACCOUNTING PRACTICE—PART I

November 8, 1961; 1:30 to 6:00 p.m.

Solution 1

	a	b	c	d	e
1.		X			
2.					X
3.					X
4.		X			
5.					X
6.		X			
7.		X			
8.				X	
9.					X
10.				X	
11.				X	
12.			X		
13.					X
14.			X		
15.	X				

	Yes	No
16.	X	
17.		X
18.		X
19.	X	
20.	X	
21.	X	
22.	X	
23.		X
24.		X
25.		X
26.		X
27.	X	
28.		X
29.	X	
30.		X
31.		X
32.		X
33.		X
34.	X	
35.	X	

Solution 2

State Gas Company
EXPLANATION OF INCREASE IN OPERATING REVENUE
Year Ended December 31, 1960

Operating revenue—year ended December 31, 1959		$1,215,000
Decrease resulting from decline in the average of customers	$(45,000)	
Increase caused by increase in average consumption per customer	130,000	
Decrease reflecting reduction in average rate per MCF sold	(26,000)	59,000
Operating revenue—year ended December 31, 1960		$1,274,000

State Gas Company

COMPUTATION OF THE EFFECT ON OPERATING REVENUE OF VARIATIONS IN AVERAGE NUMBER OF CUSTOMERS, AVERAGE RATE PER MCF, AND AVERAGE CONSUMPTION PER CUSTOMER

Year Ended December 31, 1960

	1959	*1960*
Average consumption per customer in MCF	18	20
Average rate per MCF sold	$2.50	$2.45

Average number of customers:			
1960		26,000	
1959		27,000	
Decrease in average number of customers		1,000	(a)
Average consumption per customer—1959		18	(b)
Decrease in MCF	(a) x (b)	18,000	(c)
Average rate per MCF—1959		2.50	(d)
Decrease in revenue	(c) x (d)	$45,000	
Average consumption per customer:			
1960		20	
1959		18	
Increase in average consumption per customer		2	(a)
Average number of customers—1960		26,000	(b)
Increase in MCF	(a) x (b)	52,000	(c)
Average revenue per MCF—1959		2.50	(d)
Increase in revenue	(c) x (d)	$130,000	
Average rate per MCF:			
1960		$ 2.45	
1959		2.50	
Decrease in average rate per MCF		.05	(a)
MCF sales—1960		520,000	(b)
Decrease in revenue	(a) x (b)	$ 26,000	

Solution 3

a. Ending inventory for 1960 under the conventional retail method:

Computation of December 31, 1960 inventory at retail:

Purchases at retail		$100,000
Mark-ups		7,000
Total purchases at retail as adjusted		107,000
Beginning inventory		15,000
Total available for sale at retail		122,000
Less sales	$ 95,000	
Mark-downs	2,000	97,000
Ending inventory at retail		$ 25,000

Cost to retail ratio:	*Cost*	*Retail*
January 1, 1960 inventory	$ 5,210	$ 15,000
Purchases in 1960	47,250	100,000
Mark-ups in 1960		7,000
Total	$ 52,460	$122,000
Ratio	$\frac{\$52{,}460}{\$122{,}000}$	= 43%

December 31, 1960 inventory at cost:

Inventory at retail (as computed above)	$ 25,000
Cost to retail ratio (as above)	43%
Inventory at cost under conventional retail method	$ 10,750

b. Ending inventory for 1960 under the last-in, first-out retail method:

Cost to retail ratio:

Total purchases at cost / Total purchases at retail as adjusted (see above), less mark-downs	$\frac{\$47{,}250}{\$107{,}000 - 2{,}000} = 45\%$

December 31, 1960 inventory at last-in, first-out cost:

	Retail	*Ratio*	*Lifo Cost*
Beginning inventory	$15,000		$5,210
Increase purchased in 1960	10,000	45%	4,500
Ending inventory	$25,000		$9,710

Solution 4

a.

The Neversink Corporation
STATEMENT OF AFFAIRS
June 30, 1961

Book Value	ASSETS		*Appraised Value*	*Estimated Amount Available*	*Loss or Gain* on Realization*
	ASSETS PLEDGED WITH FULLY SECURED CREDITORS				
$ 40,000	Accounts receivable		$ 40,000		
13,000	Land		25,000		$ 12,000*
90,000	Buildings		110,000		20,000*
120,000	Machinery		75,000		45,000
			250,000		
	Less fully secured claims (contra)		162,400	$ 87,600	
	ASSETS PLEDGED WITH PARTLY SECURED CREDITORS				
20,000	Marketable securities		19,000		1,000
	Accrued interest		200		200*
	Total (deducted contra)		19,200		
	FREE ASSETS				
2,000	Cash		1,500	1,500	500
30,000	Accounts receivable	$30,000			
	Add credit balances (contra)	5,000	35,000	35,000	
60,000	Finished goods		50,000	50,000	10,000
40,000	Raw material, expected to realize	70,000			
	Less cost to complete	10,000	60,000	60,000	20,000*
20,000	Goodwill		0		20,000
5,000	Prepaid expenses		0		5,000
	Estimated amount available			234,100	$ 29,300
	Liabilities with priorities (contra)			41,500	
	Estimated amount available for unsecured liabilities			192,600	
	Estimated deficiency on unsecured liabilities			18,200	
$440,000				$210,800	

Book Value	LIABILITIES AND CAPITAL		*Amount Unsecured*
	LIABILITIES WITH PRIORITY		
$ 15,000	Withheld taxes payable	$ 15,000	
	Employer payroll taxes payable	500	
15,000	Accrued wages	15,000	
	Estimated liquidation costs	10,000	
	Auditor's liquidation service fee	1,000	
	Total (contra)	$ 41,500	
	FULLY SECURED CREDITORS		
30,000	Notes payable	$ 30,000	
130,000	Mortgages payable	130,000	
	Accrued interest payable	2,400	
	Total (contra)	$162,400	
	PARTLY SECURED CREDITORS		
20,000	Notes payable	$ 20,000	
	Less appraised value of pledged accounts and collateral (contra)	19,200	$ 800
	UNSECURED CREDITORS		
65,000	Accounts payable		65,000
85,000	Notes payable		85,000
	Accounts receivable credit balances (contra)		5,000
	Unbilled auditor's fee		5,000
	Estimated liability on damage suit pending		50,000
	CAPITAL		
100,000	Capital stock		
(20,000)	Retained earnings (deficit)		
$440,000	Total unsecured liabilities		$210,800

b. Computation of estimated settlement per dollar of unsecured liabilities:
Estimated amount available for unsecured liabilities, $192,600, divided by total unsecured liabilities, $210,800, equals estimated amount payable on claims, 91% or 91¢ on the dollar.

Solution 5

a. **Computation of Sales Price and Settlement**

Book values at May 31, 1961:		
Inventories		$ 6,028,000
Property (net)		6,804,000
		$12,832,000
Less book values at December 31, 1960:		
Inventories	$5,592,000	
Property (net)	6,927,000	12,519,000
Increase in book value		313,000
Fixed amount per agreement		10,000,000
Prepaid expenses		297,000
Other assets		604,000
Total sales price		$11,214,000
Settlement:		
Jones Company note		$ 3,000,000
Assumption of liabilities		3,974,500
Cash		4,239,500
Total settlement		$11,214,000

b. **Computation of Net Loss on Sale**

Assets to be sold:	
Inventories	$ 6,028,000
Prepaid expenses	297,000
Property (net)	6,804,000
Other assets	604,000
Total book value	13,733,000
Sales price	11,214,000
Net loss before federal income tax benefit	2,519,000
Federal income tax benefit (50% × $2,294,500)	1,147,250
Net loss after federal income tax benefit	$ 1,371,750

Ecton Company

WORKSHEET GIVING EFFECT TO PROPOSED SALE

	Per Books	ADJUSTMENTS				Estimated Balance Sheet July 31, 1961
ASSETS TO BE RETAINED BY ECTON						
Cash	$ 472,000	(2)	$ 4,239,500	(3) (5) (6)	$ 2,178,750 20,000 208,500	$2,304,250
Receivables	3,105,000					3,105,000
Net assets applicable to estimated profit for 2 months ended 7/31/61		(1)	150,000			150,000
Notes receivable		(2)	3,000,000			3,000,000
Federal income tax refundable		(2)	947,250			947,250
Total Assets to be Retained	3,577,000					9,506,500
ASSETS PROPOSED TO BE SOLD TO JONES						
Inventories	6,028,000			(2)	6,028,000	
Prepaid expenses	297,000			(2)	297,000	
Property (net)	6,804,000			(2)	6,804,000	
Other assets	604,000			(2)	604,000	
Total Assets to be Sold	13,733,000					
TOTAL ASSETS	$17,310,000					$9,506,500
LIABILITIES TO BE PAID BY ECTON						
Long-term debt	$ 4,650,000					$4,650,000
Estimated federal income taxes payable	333,500	(2) (6)	200,000 208,500	(1)	75,000	
Total to be Paid by Ecton	4,983,500					4,650,000
LIABILITIES TO BE PAID BY JONES						
Accounts payable	3,052,500	(2)	3,052,500			
Accrued liabilities	922,000	(2)	922,000			
Total to be Paid by Jones	3,974,500					
STOCKHOLDERS' EQUITY						
Preferred stock	2,100,000	(3)	2,100,000			
Common stock	1,000,000					1,000,000
Paid-in capital	587,000					587,000
Retained earnings	4,665,000	(2) (3) (4) (5)	1,371,750 78,750 300,000 20,000	(1)	75,000	2,969,500
Reserve for contingencies				(4)	300,000	300,000
Total Stockholders' Equity	8,352,000					4,856,500
TOTAL LIABILITIES	$17,310,000		$16,590,250		$16,590,250	$9,506,500

Ecton Company

ADJUSTING ENTRIES
(Not required)

(1)		
Net assets	$ 150,000	
Estimated federal income taxes payable		$ 75,000
Retained earnings		75,000
To record estimated profit for June and July		
(2)		
Cash	4,239,500	
Notes receivable	3,000,000	
Estimated federal income taxes payable	200,000	
Accounts payable	3,052,500	
Accrued liabilities	922,000	
Retained earnings	1,371,750	
Federal income tax refundable	947,250	
Inventories		6,028,000
Prepaid expenses		297,000
Property (net)		6,804,000
Other assets		604,000
To record proposed sale and settlement		
(3)		
Preferred stock	2,100,000	
Retained earnings	78,750	
Cash		2,178,750
To redeem preferred stock @ $102 and pay accrued dividends		
(4)		
Retained earnings	300,000	
Reserve for contingencies		300,000
To establish reserve for contingencies		300,000
(5)		
Retained earnings	20,000	
Cash		20,000
To record regular 20¢ quarterly dividend on common stock paid June 15		
(6)		
Estimated federal income taxes payable	208,500	
Cash		208,500
To record payment on June 15 of taxes applicable to 1960 income		

Computation of Preferred Stock Redemption and Dividends

Preferred stock redeemed—21,000 shares @ $100		$2,100,000
Premium on redemption—($102 — 100) × 21,000	$42,000	
Accrued preferred dividends at July 31, 1960—21,000 × $3.00 × 7/12	36,750	78,750
Total cost of redeeming preferred stock		$2,178,750

Computation of Federal Income Tax Refundable

Retained earnings, May 31, 1961	$4,665,000
Retained earnings, December 31, 1960	4,560,000
Increase	105,000
Dividend paid on common stock, March 15, 1961	20,000
Net income for five months ended May 31, 1961	125,000
Add provision for federal income taxes	125,000
Earnings for five months ended May 31, 1961	250,000
Add:	
Earnings for two months ended July 31, 1961	150,000
Taxable income for 1960	842,500
Taxable income for 1959	639,600
Taxable income for 1958	412,400
Taxable income available for offset and for application of carry-back loss	2,294,500
Net loss on sale of assets	2,519,000
Carry-forward loss	$ 224,500
Federal income tax benefit (50% × $2,294,500)	$1,147,250
Less amount offset against 1961 income tax (50% × $400,000)	200,000
Federal income tax refundable	$ 947,250

ACCOUNTING PRACTICE—PART II

November 9, 1961; 1:30 to 6:00 p.m.

Solution 1

COMPARATIVE STATEMENTS OF OPERATIONS

	Prior Year		*Plan 1*		*Plan 2*	
	Product A	*Product B*	*Product A*	*Product B*	*Product A*	*Product B*
Sales	$120,000	$240,000	$180,000	$360,000	$154,000	$285,000
Less production cost	80,000	180,000	114,000(1)	243,000(2)	103,600(4)	210,000(5)
Gross profit	40,000	60,000	66,000	117,000	50,400	75,000
Selling expense:						
Advertising	7,200	14,400	—	—	12,320	19,950
Premium books	—	—	18,360(3)	27,540(3)	—	—
Other	14,400	28,800	27,000	43,200	18,480	34,200
	21,600	43,200	45,360	70,740	30,800	54,150
Administrative expenses	6,000	12,000	7,200	14,400	6,000	12,000
	27,600	55,200	52,560	85,140	36,800	66,150
Operating profit	$ 12,400	$ 4,800	$ 13,440	$ 31,860	$ 13,600	$ 8,850
Ratio of selling expense to sales	18%	18%	25.2%	19.7%	20%	19%
Operating profit to sales	10.3%	2%	7.5%	8.9%	8.8%	3.1%

(1) $.38 × 300,000
(2) $.27 × 900,000
(3) Premium book expense:

Product A—8 stamps × 300,000 packages	=	$ 2,400
24,000 books		360
24,000 prize units		15,600
		$18,360
Product B—4 stamps × 900,000 packages	=	$ 3,600
36,000 books		540
36,000 prize units		23,400
		$27,540

(4) $.37 × 280,000
(5) $.28 × 750,000

Solution 2

Harold and Ethel Jones

COMPUTATION OF TAXABLE INCOME FOR 1960

INCOME			
Salary from Master Engineering Corporation			$10,000
Proportionate share of 1960 taxable income of the Master Engineering Corporation under Sect. 1372 (1/3 of $25,500)			8,500
Dividends from Federal Savings and Loan Association (interest)			350
Long-term capital gain (from Master Engineering Corporation) (1/3 of $3,000)	$1,000		
Less short-term capital loss	400		
	$ 600		
50% thereof			300
Dividend income			
American Telephone Company	$ 75		
Less exclusion (owned jointly)	100	-0-	
Consolidated Water Company of Mexico			150
			19,300
Less business expense not reimbursed			1,000
Adjusted gross income			18,300
DEDUCTIONS			
Charitable contributions			
Fair market value of securities	5,000		
Sales price	3,000		2,000
Medical expenses			
Drugs and medicines	150		
Less 1% of $18,300	183	-0-	
Doctors' fees	600		
Less 3% of $18,300	549	$51	51
Total deductions			2,051
			16,249
EXEMPTIONS, 5 @ $600			3,000
Taxable income			$13,249

Master Engineering Corporation

COMPUTATION OF TAXABLE INCOME DISTRIBUTABLE UNDER SECTION 1372

Net income per books		$27,500
Add:		
Premiums on officers' life insurance		1,500
Charitable contributions		2,000
Total		31,000
Less interest from State of Illinois Bonds		1,000
Total for computation of limitation on contributions		30,000
Less allowable contributions (5% of $30,000)		1,500
Taxable income to be reported by stockholders in proportion to interests:		
As long-term capital gain	$ 3,000	
As ordinary income	25,500	
Total taxable income distributable		$28,500

BASIS IN THE STOCK OF MASTER ENGINEERING CORPORATION

Cost (in 1958)		$15,000
Share of taxable income distributable in 1960 under Section 1372	$ 9,500	
Less December 31, 1960 dividend	3,000	6,500
Basis, January 1, 1961		$21,500

Solution 3

a.

Client

ANALYSIS (IN SHARES) OF INVESTMENT
in
New Jersey Investment Trust

Shares held January 1, 1960		3,183
Shares acquired through dividend of 2/26/60:		
Dividend of $.14 on 3,183 shares	$445.62	
Less: 38 shares @ $11.55	438.90	38
To dividend income (per account)	$ 6.72	
Shares acquired on dividend of 10/24/60:		
Dividend of $.09 on 3,221 shares	$289.89	
Less: 24 shares @ $12.06	289.44	24
To dividend income (per account)	$ .45	
Shares held December 31, 1960		3,245

b.

Client

ANALYSIS OF INCOME

New Jersey Investment Trust

	Capital Gains	*Dividend Income*	*Total*
February 26, \$.14 on 3,183 shares	\$445.62		\$ 445.62
April 25, .11 on 3,221 shares		\$ 354.31	354.31
July 25, .10 on 3,221 shares		322.10	322.10
October 25, .09 on 3,221 shares	289.89		289.89
December 31, adjustment for dividend of record December 17, .11 on 3,245 shares		356.95	356.95
	\$735.51	\$1,033.36	\$1,768.87

c. Adjusting entries:

(1)

Investment in New Jersey Investment Trust	\$728.34	
Dividend income		\$728.34
To capitalize cost of shares acquired in lieu of cash (dividends of February 26, \$438.90 and October 24, \$289.44) and to recognize the related dividend income.		

(2)

Dividends receivable	\$356.95	
Dividend income		\$356.95
To record dividend receivable and dividend income resulting from the dividend declared by New Jersey Investment Trust on December 9, 1960.		

Solution 4

The Biltimar Company

COST OF PRODUCTION REPORT FOR FINISHING DEPARTMENT

For the month of July

Quantity Schedule		
Units in process, July 1		10,000
Transferred from other departments during July		40,000
Total received from other departments		50,000
Transferred to finished goods inventory during July	35,000	
Gewgaws in process, July 31	10,000	45,000
Gewgaws lost		5,000

Cost Charged to the Finishing Department

		Total Cost	Unit Cost
Costs transferred from preceding departments			
Work in process, July 1		$ 38,000	
Transferred in during July	(40,000)	140,000	$ 3.50
Costs added by Finishing Department			
Work in process, July 1			
Material		21,500	
Labor (three-fourths complete)		39,000	
Manufacturing expense (three-fourths complete)		42,000	
Total work in process, July 1		102,500	
Costs added during July			
Material		70,000	2.00
Labor		162,500	5.00
Manufacturing expense		130,000	4.00
Adjustment for lost gewgaws			.50
Total costs to be accounted for		$643,000	$15.00

Additional Computations

Equivalent production
Labor and expenses = 2,500 + 25,000 + 5,000 = 32,500 units

Gewgaw unit costs

$$\text{Material} = \frac{\$70{,}000}{35{,}000} = \$2.00$$

$$\text{Labor} = \frac{\$162{,}500}{32{,}500} = \$5.00$$

$$\text{Manufacturing expense} = \frac{\$130{,}000}{32{,}500} = \$4.00$$

Adjustment for lost gewgaws

$$\frac{\$140{,}000}{40{,}000 - 5{,}000} = 4.00 - 3.50 = \$.50$$

a. Cost of gewgaws lost in production in July
5,000 × $3.50 = $17,500

b. Costs of gewgaws transferred to finished goods inventory in July.

From beginning inventory		
Inventory value, prior departments	$ 38,000	
Inventory value, Finishing Department	102,500	
Labor added (10,000 × ¼ × $5.00)	12,500	
Manufacturing expense added (10,000 × ¼ × $4.00)	10,000	$163,000
From July production		
Units started and finished (25,000 × $15.00)		375,000
Total cost of gewgaws transferred to finished goods inventory in July		538,000

c. Cost of work in process inventory, July 31

Adjusted cost from preceding departments (10,000 × $4.00)	40,000	
Material (10,000 × $2.00)	20,000	
Labor (10,000 × ½ × $5.00)	25,000	
Manufacturing expense (10,000 × ½ × $4.00)	20,000	
Total cost of work in process inventory, July 31		105,000
Total costs accounted for		$643,000

Solution 5

CONSOLIDATION ELIMINATION AND ADJUSTING JOURNAL ENTRIES

December 31, 1960

(1)

Retained earnings	$45,000	
Investment in Designers, Inc.		$45,000
To eliminate net income of subsidiary credited to retained earnings on parent's books.		

(2)

Cash	26,000	
Accrued interest receivable		1,000
Notes receivable		25,000
To record cash in transit from subsidiary to parent representing installment and accrued interest due on note.		

(3)

Notes payable		$75,000	
Interest income		1,000	
Notes receivable			$75,000
Interest expense			1,000

To eliminate inter-company notes and related interest.

(4)

Sales and services		40,000	
Deferred charges			5,500
Cost of sales			34,500

To eliminate sales and inter-company profit relating to engineering services billed to the parent by the subsidiary.

Engineering services deferred	$16,500
Cost ($16,500 + 150%)	11,000
Inter-company profit in deferred charges	$ 5,500

(5)

Sales		60,000	
Inventories			4,000
Cost of sales			56,000

To eliminate inter-company sales and profit in inventories.

Purchases from parent included in subsidiary's inventories	$16,000
Parent company's cost computed on basis of parent's gross profit ratio (75%)	12,000
Inter-company profit in inventories	$ 4,000

(6)

Sales		25,000	
Allowance for depreciation		1,000	
Cost of sales			15,000
Cost of sales (depreciation expense)			1,000
Plant, property and equipment			10,000

To eliminate inter-company profit and adjust the provision for depreciation on assets purchased by the subsidiary from its parent.

	Asset	*Depreciation*
Sales price	$25,000	$2,500
Cost	15,000	1,500
Excess	$10,000	$1,000

(7)

Dividends payable		4,500	
Minority interest in net income		500	
Retained earnings			5,000

To eliminate dividends payable on stock held by parent company (90% × $5,000) and to reclassify dividends relating to stock held by minority interests as a deduction from consolidated income.

(8)

Capital stock	$100,000	
Retained earnings (at date of acquisition)	400,000	
Minority interest in net income	9,500	
Investment in Designers, Inc.		$430,000
Patents and licenses		25,000
Minority interest in subsidiary		54,500
To eliminate investment in subsidiary and set up minority interest therein.		

	Parent Company's Interest			Minority Interest in Net Income
	1/1/60	*9/30/60*	*12/31/60*	*Retained*
Net assets, 1/1/60	$500,000	$500,000	$500,000	
Net income:				
1/1/60 to 9/30/60		25,000	25,000	$7,500(30%)
10/1/60 to 12/31/60			25,000	2,500(10%)
Dividends declared			(5,000)	(500)(10%)
	$500,000	$525,000	$545,000	$9,500
Interest acquired	$350,000(70%)	$105,000(20%)		
Cost ($430,000)	325,000	$105,000		
Excess equity	$ 25,000*			
Minority interest			$54,500(10%)	

*To be applied to patents and licenses to reduce them to fair value.

Products Company and Subsidiary
WORKSHEET FOR CONSOLIDATED STATEMENTS December 31, 1960

DEBITS	Products Company	Designers, Inc.	Adjustments and Eliminations		Consolidated Income Statement	Retained Earnings	Consolidated Balance Sheet
Cash	$ 100,000	$ 80,000	(2) $ 26,000				$ 206,000
Notes receivable	100,000			(2) $ 25,000			
				(3) 75,000			
Accounts receivable	200,000	100,000					300,000
Accrued interest receivable	1,000			(2) 1,000			
Inventories	924,000	125,000		(5) 4,000			1,045,000
Investment in Designers, Inc.	475,000			(1) 45,000			
				(8) 430,000			
Plant, property and equipment	1,250,000	500,000		(6) 10,000			1,740,000
Deferred charges	25,000			(4) 5,500			19,500
Patents and licenses		50,000		(8) 25,000			25,000
Cost of sales	1,350,000	525,000		(4) 34,500	$1,768,500		
				(5) 56,000			
				(6) 15,000			
				(6) 1,000			
Administrative and selling expenses	251,000	174,000			425,000		
Interest expense		1,000		(3) 1,000			
Total debits	$4,676,000	$1,555,000			$2,193,500		$3,335,500
CREDITS							
Accounts payable	$ 425,000	$ 80,000					$ 505,000
Notes payable		75,000	(3) 75,000				
Dividend payable		5,000	(7) 4,500				500
Allowance for depreciation	500,000	150,000	(6) 1,000				649,000
Capital stock	300,000	100,000	(8) 100,000				300,000
Retained earnings	1,650,000	395,000	(1) 45,000	(7) 5,000		$1,605,000	
			(8) 400,000				
Sales and services	1,800,000	750,000	(4) 40,000		$2,425,000		
			(5) 60,000				
			(6) 25,000				
Interest income	1,000		(3) 1,000				
Minority interest in subsidiary				(8) 54,500			54,500
Minority interest in net income for 1960			(7) 500				
			(8) 9,500		(10,000)		
Total credits	$4,676,000	$1,555,000	$787,500	$787,500	$2,415,000		
Total debits					2,193,500		
Consolidated net profit for year					$ 221,500	221,500	
Consolidated retained earnings						$1,826,500	1,826,500
Total credits							$3,335,500

Solution 6

General Fund

CORRECTING ENTRIES

a. **(Not Required)**

2			
Estimated revenues		$10,000,000	
Appropriations			$ 9,500,000
Unappropriated surplus			500,000
To record adoption of the budget for the year.			
3a			
Revenues received		9,900,000	
Taxes receivable—current			9,500,000
Taxes collected in advance			20,000
Revenues			360,000
Licenses and permits	$250,000		
Fines and forfeits	78,000		
Rental from use of properties	32,000		
	$360,000		
Appropriation expenditures			20,000
Departmental charges	$ 10,000		
Payment on serial general obligation bonds	10,000		
	$20,000		
To reclassify cash received during the year.			
3b			
Due from Working Capital Fund		10,000	
Petty cash fund		5,000	
Appropriation expenditures			15,000
To record as assets a temporary loan and a petty cash fund amounts charged in error to Appropriation Expenditures.			
4a			
Taxes receivable—current		10,000,000	
Allowance for uncollectible taxes—current			300,000
Revenues			9,700,000
To record this year's tax levy.			
4b			
Deferred tax collections		500,000	
Taxes receivable—current			500,000
To reverse an incorrect entry.			
5			
Taxes receivable—delinquent		500,000	
Allowance for uncollectible taxes—current		300,000	
Taxes receivable—current			500,000
Allowance for uncollectible taxes—delinquent			300,000
To recognize that taxes receivable have become delinquent.			

6

Appropriation expenditures	$ 79,000	
Encumbrances	30,000	
Accrued salaries payable		$ 60,000
Accounts payable		19,000
Reserve for encumbrances		30,000

To record amounts applicable to the current year.

7

Appropriation expenditures	1,000	
Due to Working Capital Fund		1,000

To record liability to Working Capital Fund for services rendered.

8a

Stores inventory	35,000	
Reserves for stores inventory		35,000

To set up stores inventory account and reserve for inventories.

8b

Unappropriated surplus	5,000	
Reserve for petty cash fund		5,000

To record advance to petty cash fund.

CLOSING ENTRIES

(a)

Revenues	10,060,000	
Estimated revenues		10,000,000
Unappropriated surplus		60,000

To close out estimated revenues and revenue accounts.

(b)

Appropriations	9,500,000	
Appropriation expenditures		9,345,000
Encumbrances		30,000
Unappropriated surplus		125,000

To close out appropriations, expenditures and encumbrances accounts.

Crescent City
GENERAL FUND WORKSHEET
As of End of Fiscal Year

Debits	*Balances Per Books*	*Corrections and Adjustments* *Debit*	*Corrections and Adjustments* *Credit*	*Corrected Balances*
Cash	$ 600,000			$ 600,000
Petty Cash		$ 5,000(3b)		5,000
Taxes receivable—current	500,000	10,000,000(4a)	$ 9,500,000(3a) 500,000(4b) 500,000(5)	—0—
Allowance for uncollectible taxes—current		300,000(5)	300,000(4a)	
Taxes receivable—delinquent		500,000(5)		500,000
Allowance for uncollectible taxes—delinquent			300,000(5)	(300,000)
Due from Working Capital Fund		10,000(3b)		10,000
Stores inventory		35,000(5a)		35,000
Appropriations			9,500,000(2)	(9,500,000)
Encumbrances		30,000(6)		30,000
Appropriation expenditures	9,300,000	79,000(6) 1,000(7)	20,000(3a) 15,000(3b)	9,345,000
	$10,400,000			$ 725,000
Credits				
Accounts payable			19,000(6)	$ 19,000
Accrued salaries payable			60,000(6)	60,000
Due to Working Capital Fund			1,000(7)	1,000
Taxes collected in advance			20,000(3a)	20,000
Reserve for encumbrances			30,000(6)	30,000
Reserve for petty cash fund			5,000(8b)	5,000
Reserve for stores inventory			35,000(8a)	35,000
Unappropriated surplus		5,000(8b)	500,000(2)	495,000
Deferred tax collections	$ 500,000	500,000(4b)		—0—
Revenues received	9,900,000	9,900,000(3a)		—0—
Estimated revenues		10,000,000(2)		(10,000,000)
Revenues			360,000(3a) 9,700,000(4a)	10,060,000
	$10,400,000			$ 725,000

AUDITING

November 9, 1961; 8:30 a.m. to 12 m.

Solution 1

a. 1. The CPA should discuss the matter thoroughly with the client, pointing out that the changes are unacceptable from accounting and auditing standpoints and that the financial statements are grossly misleading. If the client insists on retaining the changes in accounting and refuses to correct the statements, the auditor should tell the client that his opinion on the statements will have to be adverse. In these circumstances the auditor would probably find it advisable to withdraw from the engagement.

The withdrawal should be submitted in writing promptly to enable the client to engage another auditor. The letter should explain the reasons for the withdrawal.

For future reference the CPA should prepare a complete statement of the facts for his files.

2. When the auditor has withdrawn from the engagement, he is under no obligation to reveal information to outsiders. To make any revelations would be in violation of the confidential relationship existing between auditor and client.

3. Usual professional courtesies should be extended to the successor auditor, but confidential information should not be revealed without permission of the client. If the CPA is approached by the new auditor, it is proper to suggest that he obtain permission from the client to review the working papers of his predecessor.

Refusal of permission is an indication of some irregularity; if permission is granted, then the working papers would disclose the information.

b. 1. If a true partnership exists, the CPA should discuss the matter with the managing partner and insist upon full disclosure to all partners. If the managing partner refuses to make the information available to the other partners, then the auditor should withdraw from the engagement and inform the partners of the reason for withdrawal. The withdrawal should be in writing.

2. Under a true partnership, there is a community of interest with each partner being an agent of the others. Accordingly, the client is actually all of the partners and not the managing partner alone. Therefore the CPA has the responsibility of making full disclosure to all partners without exception.

3. There is no obligation to reveal this information to outsiders inasmuch as the total partnership capital will be reported on the balance sheet.

4. No action need be taken by the CPA if, under the partnership agreement, a partner's drawings may exceed his pro rata share of the earnings.

Perhaps a true partnership does not exist. The managing partner might be, in effect, a sole proprietor who has given essential employees a nominal partnership status to enhance their prestige in partnership dealings.

Certain large partnership (generally professional firms) assign authority to a managing partner or executive committee in such a way that other partners do not have the right usually associated with partnership status.

Solution 2

1. Review and evaluate the internal control over the accounting for travel advances.
2. By reference to the subsidiary ledger cards, prepare a trial balance of the advances as of the examination date. (If the trial balance can be obtained from the client, check the details thereof to subsidiary ledger cards, and prove the footing.)
3. Determine that the total of the trial balance is in agreement with the general ledger control account.
4. For a representative number of cards trace advances from the cash disbursement records to the postings in the subsidiary ledger cards. Determine that advances were properly authorized.
5. For a representative number of cards compare expense reports with subsidiary ledger cards and trace to travel expense ledger account. Vouch these expense reports. Compare total expense with prior years for reasonableness. Investigate any monthly fluctuations in amount of travel expense.
6. Trace to cash receipts records the advances returned in cash.
7. Determine that advances are to individuals in the employ of the company by comparison with personnel records.
8. Scan the individual ledger cards for any unusual entries, amounts, credit balances, or patterns of activity during the period under audit; investigate each unusual item (by reference to expense reports and documents in support of cash advances or reimbursements, and, if appropriate, by inquiry of company officials with kowledge of activities of the employees under review) to your satisfaction. Special attention should be given to advances written off as uncollectible.
9. Consider the reasonableness of amounts permanently advanced in relation to the activity shown by the detail card.
10. Discuss with responsible supervisory personnel all nonpermanent advances outstanding for more than a reasonable period.
11. Select a representative number of advances, including those questioned in the preceding review of the detail cards, and request confirmation.
12. Follow up any confirmation exceptions received.
13. In cases in which no reply to confirmation request is received, satisfy yourself with respect to the propriety of the advance by other auditing procedures.
14. Determine that expenses have been cleared from the account as of the audit date.
15. As a further test of validity, at a subsequent date review the records of the advances to determine that they have been cleared by return of cash or by approved travel expense vouchers.

Solution 3

a. Mr. Brown's system does not provide proper internal control of unclaimed wages. Commingling different funds weakens internal control because the custodian can cover up shortages by interfund cash transfers or other manipulations.

Furthermore, with no accountability for unclaimed wages the custodian might abstract them and state they were paid to the wage earner.

The amount of responsibility that is vested in the custodian and other duties assigned to him are worthy of further consideration by the auditor. For example, does he participate in payroll preparation? Handle cash receipts?

b. Better internal control over unclaimed wages can be provided by modifying the payroll and accounting procedures. The payroll envelopes showing the employee's name and payroll details should be provided by the payroll department. Insertion of cash in the envelopes should be by a person other than the individual computing the payroll. The envelopes should be compared to the payroll records for details. All handling of payroll cash should be by persons whose duties are divorced from petty cash or cash receipt functions.

Preferably the distribution of envelopes to employees should be in the presence of a third party. Each employee should sign a receipt for his envelope. Unclaimed envelopes should be turned over to Mr. Brown or another responsible person at once.

At regular intervals the unclaimed wages should be deposited in the general cash account and an Unclaimed Wages account should be established as a current liability. Payment of any unclaimed wages from this account should require proper authorization. After a specified period the unclaimed wages should be returned to income or, if legally required, escheated to the state.

The petty cash fund should be maintained on an imprest basis and, to lessen the number of reimbursements, consideration should be given to increasing the size of the fund.

Solution 4

a. The analysis is incomplete because it does not present sufficient evidence to express an opinion as to the propriety of the transactions recorded in the account. No indication is given as to the nature of the transactions other than the disbursement and receipt of cash. Additional audit procedures will be necessary to accumulate evidence the reviewer needs.

b. There is the possibility that either of two different contractual arrangements have caused the client's transactions:

1. The construction of the barges was financed by a loan from the Eastern Life Insurance Company. Crediting the loan to the advance account results in failure to disclose the existence of the capital assets constructed and the related loan payable.
2. Paulsen sold the barges to Eastern, probably with a charter or leaseback arrangement.

c. The following auditing procedures appear necessary to complete the analysis:

1. Determine by inquiry the nature of the transactions.
2. Examine minutes of the board of directors' meetings for proper authorization. Extract details for the analysis and permanent file.
3. Examine agreements or contracts relating to the transactions. Extract pertinent provisions for inclusion in the working papers.
4. Ascertain that payments conform with the construction contracts and no unrecorded liabilities exist.
5. Confirm the transactions with the Jones Barge Construction Co., including specific requests for information regarding percentages withheld, existence of other construction contracts and warranties for barges constructed.
6. Confirm the transaction in detail with the Eastern Life Insurance Company.
7. If the transaction represents financing the construction by a loan, ascertain whether the barges are completed and, if so, determine the adjusting entries to record the asset, loan liability, depreciation and accrued interest. Establish that extra costs have been properly authorized. Ask if a certificate from an engineer or naval architect has been acquired relating to cost and performance of the barges.

   If the transaction represents sale of the barges to Eastern and subsequent chartering or leasing by Paulsen, determine the adjusting entries to record the complete transaction including gain or loss on the sale. Compute rental liability under the charter or leasing contract. Ascertain if any maintenance costs may be chargeable to Eastern as owner.
8. For the analytical review of expenses on a comparative basis, consider the significance of the costs of operating the barges, such as: Are they an expansion of the fleet? Or do they replace old barges which may have been leased?
9. Consider the nature and materiality of the transactions to determine whether footnote disclosure is required.
10. Ascertain that the transactions have been considered by the company in obtaining insurance coverage.

Solution 5

a. An unqualified opinion may be issued for the September 30 financial statements if the auditor's examination can meet generally accepted auditing standards. For example, he must satisfy himself regarding the physical inventory, assuming it is material.

To prevent the financial statements from being misleading the heavy operating losses incurred during the post balance sheet period must be disclosed by footnote or comment in the body of the report.

b. Statements may properly be prepared as of any day of any month. In this situation the auditor should be able to carry out all required audit procedures and, therefore, an unqualified opinion could be issued for the December 15 financial statement. For example, the physical inventory-taking could be observed at a date shortly after December 15 and through "cut-off" procedures, the inventory computed as of the balance sheet date, December 15.

c. In this situation the circumstances will determine whether the auditor expresses an unqualified or qualified opinion or disclaims an opinion. The circumstances to be considered are the materiality of the receivables and inventory and whether alternative procedures will satisfy the auditor.

If the amount of these assets is immaterial, the omission of generally accepted auditing procedures need not be mentioned.

If the amount is material and the auditor cannot satisfy himself by alternative procedures, he must deny an opinion except that he may render a qualified opinion if the amount is not sufficiently large to preclude an expression of opinion on the statements as a whole but is large enough to deserve mention. Note that the qualified opinion is based on the degree of materiality.

In those rare cases in which he is able to satisfy himself by other means he may render an unqualified opinion. Note that the auditor must be either wholly satisfied or not satisfied; he cannot render a qualified opinion based upon partial satisfaction.

d. Inasmuch as the auditor's name is not to be associated with the report, no opinion will be rendered. There is disagreement among auditors abut issuing "plain paper" reports. Some believe that absence of the auditor's name plainly puts the reader on notice that the report is unreliable. Conversely, it is maintained that an unsophisticated reader who receives the "plain paper" report with the verbal information that it was prepared by a CPA might be misled as to its reliability.

Solution 6

a. The confirmation of accounts receivable is a generally accepted auditing procedure. In contrast the confirmation of accounts payable is not a generally accepted auditing procedure although the procedure may be followed if the auditor deems it appropriate.

Two reasons may be given for the foregoing differences. First, management fraud would tend to overstate the assets and understate the liabilities. Second, the evidence supporting accounts receivable records is usually supplied by the company's internally-produced documents; whereas the evidence supporting accounts payable, such as invoices and statements, is produced by outside sources.

For these reasons the emphasis of the accounts receivable audit is to obtain evidence supporting the amount recorded. On the other hand, determining that all payables are recorded is the primary purpose of the accounts payable audit. It follows that confirmations are very useful in supplying supporting evidence for receivables but that auditing procedures other than confirmation are required to verify that all payables are recorded.

b. Accounts receivable confirmation requests may be either positive or negative in form depending upon the circumstances. Both types state the balance on the records of the creditor. The positive type requests the debtor to return the request to confirm the balance and to set forth any differences. The negative type requests a reply only if the debtor does not concur that the amount is correct.

Usually accounts payable confirmation requests do not state an account balance. The request might also ask for information regarding purchase commitments, assets pledged as security and collateral placed with the creditor. The requests are always positive in form.

c. The amount of confirmation requests to be made for both accounts receivable and accounts payable would be determined by the degree of internal control.

Accounts receivable to be confirmed on a positive basis would be selected from the following groups:

1. Accounts with large balances to account for a major part of the total dollar value of receivables.
2. Accounts placed with collection agencies or the customers are bankrupt, in receivership or in other financial difficulties.
3. Accounts in dispute.
4. Old or inactive accounts.
5. A representative number of accounts with small balances.
6. Accounts that have been written off as uncollectible.
7. Accounts with credit balances.

Negative accounts receivable confirmation requests are employed in the audit of public utilities or other firms with a great number of accounts with small balances.

The selection of accounts payable for confirmation would be from the following groups:

1. Large accounts including important suppliers even though the closing account balance is small.
2. Accounts for which monthly statements are unavailable.
3. Accounts with unusual transactions.
4. Accounts with parent or subsidiary companies.
5. Accounts with pledged assets.
6. Accounts with debit balances.

Solution 7

a.

Carr Corporation
WORKSHEET SHOWING DISTRIBUTION OF INSURANCE ACCOUNT

		Year 1959				Year 1960			
Date	*Amount*	*Insurance Expense*	*Prepaid Insurance*	*Other*		*Insurance Expense*	*Prepaid Insurance*	*Other*	
1959									
January 3	$ 6,000	$ 6,000							
20	1,900	1,900							
July 15	3,600	500	$ 3,100			$ 1,200	$ 1,900		
September 15	1,800	600	1,200			$1,200			
October 1	340*	30*	310*			120*	190*		
30	500			Insurance claim receivable	$ 500				
1959 Sub total	13,460	8,970	3,990		500	2,280	1,710		
1960									
January 3	6,000					6,000			
16	300	300		Insurance payable	300*				
17	500							Building	$ 500
18	2,200					2,200			
February 1	3,000	500	2,500	Insurance payable	3,000*	2,500			
March 1	500*							(Effect of this item recorded in 1959)	
May 10	2,650					750	1,900		
June 1	150					150			
September 15	1,800					600	1,200		
November 10	1,100							Insurance claim receivable	1,100
December 12	1,700*							Cost of goods sold	1,700*
1960 Sub total	15,500	800	2,500		$3,300*	12,200	3,100		100*
December 31						500	2,500	Insurance payable	3,000*
31						600*		Cash surrender value of life insurance	1,200
31								Prior year adjustments	600*
31						360*		Miscellaneous income	360
31						300*	300		
Totals	$28,960	9,770	$ 6,490		$2,800*	13,720	$ 7,610		2,140*
Expense recorded on books		13,460				15,500			
Expense adjustment		$ 3,690*				$ 1,780*			
								Retained earnings	3,690*
									$5,830*

*Credit

b. Prepaid insurance	$6,490	
Insurance claim receivable	500	
Accrued insurance payable		$3,300
Insurance expense		3,690
To adjust insurance expense and accruals for 1959.		

c. Prepaid insurance	7,610	
Building	500	
Insurance claim receivable	1,100	
Cash surrender value of life insurance	1,200	
Miscellaneous income	360	
Cost of goods sold		1,700
Insurance payable		3,000
Insurance expense		1,780
Prior year adjustments		600
Retained earnings		3,690
To adjust insurance expense and accruals for 1960.		

Note: The cash surrender value of the life insurance policy might alternatively be recorded in 1959 as a reduction of Insurance Expense in the amount of $600. The worksheet entry for 1959 would then record the Cash Surrender Value of Life Insurance amount as $600 and Insurance Expense as $4,290.

Accordingly, the worksheet entry for 1960 would record the increase in Cash Surrender Value as $600 and there would be no credit to Prior Year Earnings.

COMMERCIAL LAW

November 10, 1961; 8:30 a.m. to 12 m.

Solution 1

	A	*B*	*C*	*D*	*E*
1.					X
2.		X			
3.	X		X	X	
4.		X	X		
5.	X	X	X	X	X
6.	X	X	X		
7.		X	X	X	
8.	X	X	X	X	
9.	X		X	X	
10.	X			X	
11.	X	X		X	
12.		X	X	X	
13.		X	X		
14.	X	X	X	X	
15.	X		X	X	

Solution 2

	A	*B*	*C*	*D*	*E*
1.				X	
2.				X	
3.		X	X	X	X
4.		X		X	X
5.	X	X			
6.	X	X	X	X	X
7.	X		X		X
8.		X		X	
9.	X	X	X		
10.			X	X	
11.	X		X	X	X
12.	X	X	X		X
13.		X	X		
14.	X		X	X	
15.				X	

Solution 3

a. 1. Yes. Tom and Neil will be liable as general partners and as such they will be personally liable to the extent that firm debts are not satisfied out of firm assets.

Section 7 of the Uniform Limited Partnership Act provides that "A limited partner shall not become liable as a general partner unless in addition to the exercise of his rights and powers as a limited partner, he takes a part in the control of the business." The activities engaged in by Tom and Neil, to wit: determining the types of crops to be planted, drawing checks on the firm account and ousting Jerry, would certainly constitute an exercise of "control of the business." Therefore, unlimited liability would be imposed upon these two partners.

2. Yes. Jay would be personally liable, but only to the unsatisfied creditors who had no knowledge of the fact that Jay was in reality a limited partner.

   Section 5 of the Uniform Limited Partnership Act provides that "a limited partner whose name appears in a partnership name . . . (reference to exceptions not herein applicable deleted) is liable as a general partner to partnership creditors who extend credit to the partnership without actual knowledge that he is not a general partner."

   Under the facts herein Jay would not have liability on the same basis as his fellow limited partners in that he did not exercise any control of the business or participate in management. However, he will be liable to all creditors who extended credit and were unaware of his being a limited partner. From the facts both types of creditors are involved.

b. Section 23 of the Uniform Limited Partnership Act provides for the following order of distribution of assets upon dissolution:

   "(a) Those to creditors, in order of priority as provided by law, except those to limited partners on account of their contributions, and to general partners,

   "(b) Those to limited partners in respect to their share of profits and other compensation by way of income on their contributions,

   "(c) Those to limited partners in respect to their capital contributions,

   "(d) Those to general partners other than for capital and profits,

   "(e) Those to general partners in respect to profits,

   "(f) Those to general partners in respect to capital."

Solution 4

a. 1. A "preference" as defined by Section 60 of the Bankruptcy Act, as amended, "is a transfer . . . of any of the property of a debtor to or for the benefit of a creditor for or on account of antecedent debt, made or suffered by such debtor while insolvent and within four months before filing by or against him of the petition initiating a proceeding under this Act, the effect of which transfer will enable such creditor to obtain a greater percentage of his debt than some other creditor in the same class."

   2. The finance company will prevail based upon the above definition as applied to the facts of the case. The secured interest was not given for an antecedent debt. In addition, it was perfected by filing prior to the four months period from the date of filing of the petition in bankruptcy. Therefore, the creditor has a valid lien upon the property. The finance company, by fulfilling the applicable trust receipts filing requirements has good title as against any subsequent lien creditor and this is sufficient under the Act to qualify him as a secured creditor in bankruptcy.

   3. A transfer for new and contemporaneous consideration is not within the

scope of the preference provision of the Bankruptcy Act. It represents merely a substitution of one kind of assets for another.

b. The six acts of bankruptcy are:
   1. A fraudulent conveyance. This act is committed by the debtor's transferring or concealing any part of his assets, or permitting another to transfer or conceal the debtor's assets, with an "intent to hinder, delay or defraud creditors."
   2. The making or suffering a preferential transfer. This act is committed by the debtor's transferring or permitting a transfer of any part of his property, while insolvent and within four months of the filing of the petition, to one or more creditors, for or on account of an antecedent debt.
   3. A failure to discharge a lien by legal proceedings while insolvent. This act is committed by the debtor's permitting a creditor to obtain a lien through legal proceedings, while the debtor is insolvent, and failing to vacate or discharge the lien within thirty days.
   4. An assignment for the benefit of creditors. This act is committed by a voluntary transfer by the debtor of all his assets to an assignee or trustee to be sold or otherwise liquidated for the benefit of those creditors who wish to participate.
   5. The appointment of a receiver or trustee. This act is committed by the debtor's permitting or procuring, voluntarily or involuntarily, the appointment by the court of a receiver or trustee, while the debtor is insolvent.
   6. A written admission of bankruptcy. This act is committed by the bankrupt's admitting his inability to pay his debts and his willingness to be adjudicated a bankrupt.

Solution 5

a. 1. Harry will claim that there has been a discharge by "accord and satisfaction." The phrase is applied to an agreement between two parties to give and accept something in satisfaction of a right of action which one has against the other. The agreement (the accord), when performed (the satisfaction), is a bar to all actions upon the former right. Here, the cashing of the check operated as an accord and satisfaction.
   2. The entire debt was discharged. In order to have a discharge of a debt by an accord and satisfaction there must be an unliquidated amount, i.e., an amount which is honestly disputed, and the party cashing the check must be aware of the fact that the lesser amount is intended as payment in full. Neither the contractor's statement purporting to refuse the payment as a full satisfaction nor the striking out of the language on the back of the check indicating that payment in full was contemplated prevents the operation of the satisfaction.

b. No. Since there is a matured liquidated debt (i.e., one which is not open to honest dispute), the cashing of the check will not operate as an accord and a satisfaction. The debtor will be discharged only upon performance of the entire obligation. If the law did not so provide, this device might be used by unscrupulous parties to avoid paying in toto their just debts.

Solution 6

a. A shareholders' derivative action is a suit brought by a shareholder in the name of, and for the benefit of, the corporation based upon impairment of the value of his shares by reason of mismanagement or wrongful acts by directors or third persons. The suit is brought in equity by the shareholder if the corporate management wrongfully fails or refuses to sue on the corporate right of action.

b. No. The directors of a corporation, as such, are not entitled to compensation for performing the ordinary duties of their office, unless there is an express contract made in advance or an express provision for compensation in the charter or by-laws. The attempt to vote bonuses for past services without any prior understanding in regard to these services is invalid. Therefore, the directors must return the bonuses which were wrongfully paid to them.

c. Any recovery that is obtained in a derivative shareholder's action inures to the benefit of the corporation. The money may either be paid directly to the corporation or, if paid to the shareholder who successfully brought the action, held by him in trust for the benefit of the corporation. He must account for it and turn it over to the corporation.

Solution 7

a. The insurance proceeds on the building and equipment must be retained as a part of the corpus and the insurance proceeds representing lost income should be held for the benefit of, or paid to, the life beneficiary.

As a general rule, sums received on an insurance policy in settlement of claims arising out of damage to the corpus are treated as corpus. Such sums will be used to repair or replace the damaged or destroyed property. However, payments received on a policy specifically taken out to cover lost income will be treated as income and the life beneficiary will be entitled to receive same.

b. In the absence of any provision in the trust agreement, the stock dividend of 100 shares of M Company stock is treated as income and the life tenant is entitled to same. The M Company stock is a dividend in kind and is comparable to a cash dividend in its benefit to the stockholder.

c. In the absence of any provision in the trust agreement, the X Trust Company should treat the stock split-up and the proceeds from the sale of the 1,000 shares, received as a result of the split-up, as an addition to corpus. The fact that the stock had appreciated in value does not alter the above rule in that profits on the sale or exchange of any part of the corpus are ordinarily corpus.

d. Yes, X will be liable for the $500 loss. A trustee, as a fiduciary, must keep the trust funds separate from his own funds, i.e., he must not commingle them. Under this rule the trustee will be liable for any loss that occurs even though he acted innocently and in good faith. The trustee is, in effect, an insurer in respect to commingled funds.

Solution 8

a. The relationship of a public accountant to his client is that of an independent contractor, not an employee. An independent contractor is one who exercises some independent calling, occupation, or employment in the course of which he undertakes, supplying his own materials, servants and equipment, to accomplish a certain result, not being subject while doing so to the direction and control of his employer, but being responsible for the end to be achieved rather than the means necessary to accomplish it.

b. The legal responsibility of the accountant as an independent contractor is basically the same as that of other skilled professions. He must possess at least the average degree of learning and skill in his profession and he must exercise that learning and skill with reasonable care. The failure to exercise this requisite care will constitute negligence and he will be liable on this basis to his client and to others who were the parties intended to be benefited by the work.

c. With the exception of third party beneficiaries, the accountant's legal responsibility for negligence is based on the contract and does not extend beyond the obligation owed to his client or clients. However, liability for actual fraud extends to third persons even though they are not clients or intended to be the beneficiaries of the accountant's engagement.

d. (1) The Securities Act of 1933.
   (2) The Securities and Exchange Act of 1934.
   (3) The Internal Revenue Code of 1954.
   (4) The Investment Companies Act of 1940.

e. (1) A privileged communication is a communication which the law refuses, on the grounds of public policy, to allow to be disclosed in evidence.
   (2) In the case of confidential communications between accountant and client there is no privilege recognized by common law.
   (3) In that the privilege belongs to the client and not the accountant, only the client has the right to waive it.

THEORY OF ACCOUNTS

November 10, 1961; 1:30 to 5:00 p.m.

Solution 1

1.	G
2.	C
3.	F
4.	M
5.	B
6.	O
7.	K
8.	A
9.	B
10.	M
11.	A
12.	M
13.	F
14.	G or A
15.	M
16.	C
17.	X-K
18.	G
19.	X-A
20.	A
21.	K
22.	M
23.	O
24.	G
25.	G

Solution 2

a. The "natural business year" of an enterprise coincides with that twelve-month period ending on a date when the business activities have reached the lowest point in their annual cycle. Generally, inventories, receivables and payables are reduced to their minimum.

b. The reasons for adoption of a natural business year include the following:
   1. Inventories, receivables and payables are generally at their lowest amount,

and therefore the enterprise is in its most liquid and favorable position for statement purposes.

2. Future planning of the company is simplified. There is a natural break for changeover in cost standards, establishment of sales objectives and quotas, and the adoption or modification of a budget. Planning for future expansion or financing would be facilitated because a complete financial operation is presented.
3. A more efficient and economical audit by independent auditors would be permitted. The audit would not necessarily be performed at the peak of the audit and tax season. Moreover, the company's own accountants would have more time available for preparation of subsidiary trial balances and analytical statements which would reduce the audit time of the outside auditing firm.
4. Financial statements give results over a natural business cycle affording a better comparison not only between companies in the same industries but with other industries as well.
5. The difficulty of year-end adjustments and closing is reduced because incomplete transactions are at a minimum and the estimates required for valuing inventories and accounts receivable are simplified.
6. The cost of inventory-taking and valuation of the inventory is reduced because of the reduction in inventory and relatively small amount of work-in-process. Furthermore, the physical inventory may not interfere with production and qualified personnel may be available.
7. The workload of the accounting department is eased because there would be no conflict with the preparation of annual government payroll and information returns filed on a calendar year basis unless the natural business year coincided with the calendar year.

Solution 3

a. Arguments for capitalizing leaseholds on the tenant's books are as follows:
   1. Liabilities exist under the leasehold and should be revealed to outside investors and kept before the management.
   2. Disclosure of the liability by footnote might not be properly related, by the reader of financial statements, to the over-all financial structure of the firm. Furthermore, interim statements prepared for management might not include footnotes.
   3. An investor could make better standard financial ratio comparisons of companies leasing and companies purchasing facilities. More realistic comparisons could be made of returns on capital investments, utilization of capital assets and results attained by management.
   4. Leasing is an alternative to purchasing and perhaps to borrowing; capitalization would recognize this fact.
   5. Management could make better comparisons of operating results of divisions using different proportions of leased facilities.
   6. Vulnerability to volume changes would be revealed. A large fixed rental obligation should be of paramount interest to an investor and to management.

7. Capitalizing would be more in accordance with the accounting principles of revealing all assets and recognizing liabilities in the period incurred than the existing practice of footnoting leasehold liabilities and ignoring leased facilities.
8. Capitalizing would be in agreement with the concept that statements are presented on a "going-concern" basis rather than a "liquidation" basis. Thus, from a "going-concern" standpoint, the leasehold is an asset and the contractual liability exists although it comes due only with the passage of time.

Arguments against capitalizing leaseholds on the tenant's books are as follows:

1. The facilities are not actually owned by the tenant and recording the leasehold might be deceptive. This could be overcome by using an account title such as "Capitalization of leased facilities."
2. There would be a violation of the accounting principle that liabilities should be recorded only when assets or services are received.
3. Computation of the amount of the asset and liability is difficult and authorities are not in agreement on the method of computation.
4. Likewise, authorities disagree on the method of presentation in the balance sheet of the asset and liability.
5. The tax deductibility of rental payments might be impaired because the leasehold amortization would differ from cash payments. This argument is weak because other acceptable areas of accounting are in disagreement with income tax procedures.
6. The over-all rate of return on total assets is reduced which might lead investors to place a lower valuation on the firm's earnings.
7. Computation of return on capital by regulated industries might be distorted. Similarly, there might be distortion of the investment base for proposed rate structures.
8. The inclusion of the liability increases the total indebtedness of the company, which might impair borrowing capacity.
9. Local tax problems might be incurred where the governmental entity levies taxes on total capital or total assets.

b. Under the following circumstances a leasehold might require recognition on the tenant's books:
   1. The tenant has made a payment to purchase leasehold rights from a preceding lessee. The amount should be amortized over the appropriation period.
   2. The tenant has made a large advance rental payment or bonus when the lease is arranged. The amount should be amortized over the appropriate period.
   3. There are substantial penalties for nonrenewal of the lease. If the lease is not to be renewed, the liability and the related cost should be recognized.
   4. There are heavy estimated costs of reconditioning or restoring leased facilities at the termination of the lease. The liability should be accumulated over the life of the lease by charges to leasehold expense.

Solution 4

a. A reserve for sinking fund on the borrower's books contributes to the protection of the creditors because its creation requires the appropriation of retained earnings in an amount equal to the sinking fund payments. The purpose of the appropriation is to avoid a working capital impairment resulting from dividend payments and sinking fund payments.

b. Other provisions which could be included in a bond indenture for the protection of the creditors include:

1. Establishment of the sinking fund with a trustee to assure segregation of sinking fund assets and that sound investments are made for the fund.

2. Authorization for the sinking fund trustee, using funds in excess of interest requirements, to buy in the open market bonds covered by the sinking fund. Cancellation of the bonds would reduce interest requirements (but would also affect adversely the accumulation of the fund). Such purchases might be made at less than the original issue price of the bonds. Furthermore, there is no chance of loss on such investments held in the sinking fund.

3. A restriction of working capital to deter payment of dividends or other use of cash, such as purchase of additional fixed assets. The restriction would be some assurance that a satisfactory amount of working capital would be maintained.

4. Setting forth a minimum cash balance as an additional protection beyond restriction of working capital. Even though the working capital restriction was met, there might be little cash on hand because of excess inventories, overdue receivables, etc.

5. "Freezing" the retained earnings (or a stated portion thereof) at the date of the issuance of the bonds to prevent depletion of working capital by payment of dividends. Appropriating retained earnings for a sinking fund reserve would not entirely safeguard against working capital impairment because dividends could be paid from the unappropriated retained earnings.

6. Specifying that the sinking fund contributions are to be a percentage of income rather than fixed in amount. In periods of low income, fixed contributions could drain working capital and weaken the company's financial structure.

7. Providing a conversion feature to permit bondholders to convert holdings to common stock. The protective feature is effective in periods of inflation when a low market value for the bonds might cause loss to the holder selling his bonds.

8. Establishing a minimum length of time the bonds must be outstanding. Early redemption or refunding of bonds by the company might result in loss to the large investor who would have the problem and expense of reinvesting his funds.

Solution 5

a. January 3, 1960

Compensation chargeable to prior periods (or Retained earnings)	$3,000	
Executive compensation	3,000	
Deferred executive compensation	3,000	
Capital represented by stock options		$9,000

To record options granted to the president to purchase 3,000 shares of $10 par value common stock at $14 per share: 1,000 shares for services rendered in 1959; 1,000 shares for services to be rendered in 1960; and 1,000 shares for services to be rendered in 1961. The options are exercisable during the six months following the year in which the services were rendered.

COMPUTATION OF VALUE OF STOCK OPTIONS

Market value on date of grant (3,000 shares × $17)	$51,000	
Option price (3,000 shares × $14)	42,000	
Value of stock options	$ 9,000	
April 1, 1960		
Cash	$14,000	
Capital represented by stock options	3,000	
Common stock		$10,000
Paid-in capital in excess of par value		7,000
To record exercise of option by president under the stock option plan.		
June 30, 1961		
Capital represented by stock options	3,000	
Paid-in capital arising from lapsing of stock options (or Donated Capital)		3,000
To record lapsing of president's stock option.		

b. The principles involved in accounting for stock option plans are concerned with determining the existence of compensation, measuring the compensation, and disposing of lapsed options.

The primary factor in ascertaining whether the option involves compensation is the relationship of the stated price at which the stock may be purchased to the market value. An additional consideration is the employment terms of the contract granting the stock option. An option to purchase stock at a price below the current market value with the option contingent upon some aspect of employment or rendering of services clearly indicates compensation. To overlook the compensation feature would cause an overstatement of income and an understatement of costs. Should the option price be higher than the current market price, the option does not represent compensation, but perhaps, incentive.

The amount of compensation is measured as the excess of the market value of the stock over the option price on the date the option was granted. The date of the grant is selected because it is the value on that date which both parties presumably have in mind at the time of entering into the contract. Moreover, it is the date on which the company foregoes the alternative use of the shares placed subject to the option, that is, the sale of the shares at the prevailing market price. An additional factor to consider is the savings through avoidance of expenses ordinarily incurred in the sale of shares.

When rights are permitted to lapse, it is analogous to the situation in which the amount paid on an ordinary stock subscription is later forfeited. Personal services are forfeited instead of cash. In both situations the credit covering the investment is a capital item and should be included with total capital received.

Solution 6

a. The "current operating performance" income statement is intended to provide in the last item on the statement the best possible indication of the earning power of the business. Under this concept the importance of the amount of recurring net income, the indication of earning power, requires that all material extraordinary and nonrecurring items be reported as adjustments of retained earnings. Only items of revenue and expense applicable to the regular operations of the current period should be used in ascertaining net income for the period.

The "all-inclusive" income statement may be said to have been prepared on the "clean surplus" theory. All extraordinary and nonrecurring items, regardless of their materiality, are included in the determination of periodic net income. Thus a series of income statements will reveal all income information for the periods covered by the statements.

b. An income statement prepared strictly on the current operating performance basis would show the operating expenses deducted from revenues (gross or net) to display the income from the operations which characterize the business. Recurring financial items are then added or deducted to produce net income.

An income statement prepared strictly on the all-inclusive basis would show the same calculation of income from operations as does the earning power concept statement. Then the nonoperating and nonrecurring items and corrections of prior periods' profits would be added or deducted to produce net income.

There is substantial agreement that over the years all profits and losses should be accounted for in income, and a starting presumption is that all items of profit and loss recognized during an accounting period should be reported in the income of that period. However, it is recognized that readers of income statements draw inferences from a company's reported net income figure. If the total of extraordinary charges and credits is so great as to cause misleading inferences to be drawn from the reported net income figure, these material extraordinary charges and credits should be treated as retained earnings items. Specific examples of such extraordinary items are (1) material adjustments of prior periods' profits, (2) material gains and losses from the sale of assets not acquired for resale and not of the type in which the company generally deals, (3) material losses of a type not usually insured against, (4) the write-off of a material amount of intangibles and (5) the write-off of material amounts of unamortized bond discount or premium and bond issue expenses at the time of the retirement or refunding of the debt before maturity.

c. Arguments advanced for the "all-inclusive" income statement are:

1. Extraordinary items are related to income determination and net income for the period would be misstated if excluded.

2. All items should be included so that the income statements over a period of years will aggregate the company's total income.
3. Readers of the financial statements might be unaware that the statement of retained earnings should be read as well as the income statement to determine the results of the year's activities. Items handled through retained earnings might be overlooked.
4. Often there is no clear division between extraordinary items and operating items—frequently the distinction is a matter of opinion.
5. Charges and credits to retained earnings imply that the items are nonrecurring, but such items do recur.
6. There is a tendency for retained earnings charges to exceed credits so that, over a period of years, the income statements would exaggerate the company's earning power.
7. Retained earnings charges and credits create an opportunity for manipulation or normalization in the determination of net income.
8. Inconsistencies in determining extraordinary items affect the comparability of the company's earnings with prior years and with earnings of other companies.
9. The reader's attention is directed to the estimated and tentative nature of the income statement when corrections of prior years' net income are included.

Arguments offered for the "current operating performance" income statement are:

1. The earning power of the company is of interest to investors and others. Only normal operations produce the net income in which they are interested.
2. When nonrecurring items are included in the income statement, some readers are unable to determine the results of normal operations.
3. Inclusion of nonrecurring items causes difficulty in determining the trend of the company's operations and in comparing the results of operations with others.
4. There is a distortion of income for two years when a material correction of a prior year's net income is reported in the income statement.

Proponents of the combined "statement of income and retained earnings" argue that:

1. The statement carries out the theory that the income statement is the connecting link between retained earnings at the beginning and end of the period.
2. Including beginning and ending totals of retained earnings is desirable as a means of linking together the income statement and the balance sheet.
3. All factors affecting retained earnings during the period are combined in one statement so that none will be overlooked.
4. The statement distinguishes current charges and credits related to usual business operations from extraordinary charges and credits by placing them in different sections of a continuous statement.

Solution 7

a. Income tax allocation is the process of apportioning to normal income only the taxes applicable to that income and apportioning to extraordinary items the difference between the actual taxes and taxes assigned to normal income. The difference must be material in amount. Income tax allocation is referred to as accounting recognition of deferred income taxes. As a result of allocation the income statement would display the provision for taxes applicable to the income reported in that statement and not necessarily the amount of the tax liability for the current year.

The conditions calling for income tax allocation frequently arise when different depreciation methods are used for income tax purposes and for financial accounting purposes. The requirement for income tax allocation is applicable to a single asset, or to a group of assets with the same service life; there would be a tax deferment for a definite period because the excess depreciation taken in early years for tax purposes would be followed by the opposite condition in later years. The requirement is also applicable to a group of assets consisting of numerous units of various lengths of life which are being replaced continually; the excess depreciation taken in early years would be followed in later years by relative equality in the amounts of depreciation reported by the two methods, and the amount of the tax deferment built up in the earlier years would remain relatively constant. Further, the requirement applies to a gradually expanding plant; in the latter case the amount of the tax deferment would increase as long as the expansion continued.

The amount of deferred tax may be recorded in a deferred tax account which would be listed in the balance sheet as a liability or deferred credit; the account must not be listed as part of stockholders' equity. If the difference will continue for a long or indefinite period, the amount may be added to accumulated amortization or depreciation applicable to the assets in recognition of a decline in the usefulness of an asset due to the loss of future deductibility for income tax purposes.

Arguments advanced in favor of income tax allocation include:

1. A better matching of revenues and expenses.
2. Reduction or elimination of distortion when material amounts entering into computation of the income tax liability are not shown in the income statement, or
3. When material amounts included in the income statement do not enter into computation of the income tax liability.
4. Tax allocation is the treatment of income taxes on an accrual basis consistent with other items accounted for.
5. The allocation feature is in accordance with the increasing emphasis on the income statement as opposed to the balance sheet.

b. The following arguments have been advanced in opposition to income tax allocation:

1. Allocation of taxes involves a form of income normalizing or smoothing.
2. Applicable future income tax rates or other rules of determining taxable in-

come may change materially and make the amount of tax deferral inappropriate.

3. As long as there is a continued expansion of depreciable assets the deferred tax applicable to accelerated depreciation will not actually be payable.
4. The validity and reality of deferred charge and deferred credit accounts for taxes depend upon continued realization of taxable income by the entity in future periods.
5. Where a loss is charged to retained earnings net of income tax savings, the amount shown for income taxes in the income statement would be greater than the amount of the tax estimated to be actually payable.
6. The amount of income taxes attributable to accounts other than income is not reasonably determinable.
7. In situations where the timing differs for accounting and tax purposes, there will be a "balancing-out" of the dollar differences thus the periodic differences will cancel out in time.
8. Since it is unlikely that tax deferments will be precisely balanced off in the future, permanent residuals from the effects of tax allocation will result.
9. Classification of deferred tax credits is not uniform although they are not part of capital.
10. It is difficult to fit the deferred income tax accounts into the standard definitions of assets and liabilities since they do not represent things of value owned or legal obligations.
11. Income taxes are not necessarily a cost because they are paid only if period revenues exceed period costs therefore tax payments are somewhat akin to dividend payments.
12. The "allocation" procedure is complex and, because of its inconsistency with existing rules and definitions, not readily comprehensible to the statement reader.

Answers to Examinations, May 1962

ACCOUNTING PRACTICE—PART I

May 16, 1962; 1:30 to 6:00 p.m.

Solution 1

1.	C	16.	True
2.	D	17.	True
3.	C	18.	False
4.	B	19.	False
5.	B	20.	True
6.	E	21.	False
7.	D	22.	False
8.	D	23.	False
9.	B	24.	True
10.	E	25.	False
11.	C	26.	False
12.	A	27.	False
13.	D	28.	True
14.	D	29.	False
15.	B	30.	False

Solution 2

a.

COMPUTATION OF CONSOLIDATED CO. NET BOOK VALUE AT JANUARY 31, 1962

Capital stock			$ 17,000
Retained earnings			101,100
Total stockholders' equity			118,100
Less:			
Investment in Industries, Inc.		$7,700	
Total Industries, Inc. liabilities	$50,900		
Less Industries, Inc. assets	37,900		
70% thereof	$13,000	9,100	16,800
Adjusted net book value			$101,300

COMPUTATION OF CONSOLIDATED CO. NET BOOK VALUE AT APRIL 30, 1962

Capital stock			$ 17,000
Retained earnings			107,200
Total stockholders' equity			124,200
Less:			
Investment in Industries, Inc.		$19,950	
Total Industries, Inc. liabilities	$31,550		
Less Industries, Inc. assets	15,500		
	16,050		
Less adjustment for loss on sale of assets to minority stockholder	6,100	9,950	29,900
Adjusted net book value			$ 94,300

b.

COMPUTATION OF ADJUSTMENT TO TENTATIVE PURCHASE PRICE

Adjusted net book value, January 31, 1962	$101,300
Adjusted net book value, April 30, 1962	94,300
Reduction of tentative purchase price	$ 7,000

Solution 3

a.

Baker Construction Company

ESTIMATED LOSS ON CONTRACT FOR 1961

		Estimated *Cost*	Estimated *Sales Price*
Original contract price			$2,730,000
Original contract cost estimate ($2,730,000 ÷ 105%)		$2,600,000	
Increase in labor hours over estimate			
Total hours to date	65,800		
Additional hours to complete	65,000		
Total	130,800		
Original estimate	92,000		
Increase	38,800 × $3.25 =	126,100	
Increase in cost and contract price for increase in basic hourly labor rate			
4% × $3.25 =	$ .13 per hour		
Hours to complete job	65,000		
Increase	$8,450	8,450	8,450
Increased material costs to date			
Original estimate ($1,375,000 × 90%)	$1,237,500		
Actual, per purchase orders	1,250,000	12,500	
Increase in cost of material to be purchased ($1,375,000 × 10% = $137,500 × 7%)		9,625	
Savings on electrical subcontract			
Original estimate	$ 130,000		
Subcontract price	127,500	(2,500)	
Addition of air conditioning system		40,000	42,000
Total estimated cost and sales price		$2,794,175	$2,780,450

Total contract estimated cost	$2,794,175
Estimated contract selling price	2,780,450
Total estimated loss on contract—to be recognized in 1961	$ 13,725

b.

COMPUTATION OF UNBILLED COSTS

Costs incurred to date	$1,605,000
Less loss to be absorbed by Baker Construction Company	13,725
Total billable costs	1,591,275
Total billings to date	1,500,000
Total unbilled costs	$ 91,275

Solution 4

a.

T and A Discount Sales

COMPUTATION OF UNRECORDED RETURNED MERCHANDISE

December 31, 1961

Opening inventory:				
Contributed by Allen				$10,000
Contributed by Ball				8,000
Purchases				36,000
Accounts payable				15,000
Total available for sale				69,000
	Toys	*Appliances*	*Total*	
Cash sales	$35,000	$35,000	$70,000	
Mark-up on cost	40%	25%		
Cost of sales	$25,000	$28,000	$53,000	53,000
Inventory prior to liquidating sales				16,000
Receipts from liquidating sales (50%)	$ 3,500	$ 3,500	$ 7,000	
Liquidating sales at regular selling price (100%)	$ 7,000	$ 7,000	$14,000	
Mark-up on cost	40%	25%		
Cost of liquidating sales	$ 5,000	$ 5,600	$10,600	10,600
Inventory for which no sales were reported—presumably, unrecorded returned merchandise				$ 5,400

b.

T and A Discount Sales

STATEMENT OF INCOME AND EXPENSE

January 2-December 31, 1961

Cash sales		$70,000
Liquidating sales		7,000
Total sales		77,000
Cost of sales:		
Total available for sale	$69,000	
Less unrecorded returned merchandise	5,400	63,600
Gross profit		13,400
Expenses:		
Operating expenses	26,000	
Leasehold improvements	6,000	
Liquidating expense	4,000	36,000
Total loss		$22,600

c.

T and A Discount Sales

STATEMENT OF PARTNERS' CAPITAL ACCOUNTS

January 2-December 31, 1961

	Allen	*Ball*	*Total*
Profit and loss ratio	50%	50%	100%
Initial capital contributions	$10,000	$10,000	$20,000
Due on accounts payable	9,740	5,260	15,000
Total	19,740	15,260	35,000
Loss for the year	11,300	11,300	22,600
Total	8,440	3,960	12,400
Cash distribution	3,500	3,500	7,000
Total	4,940	460	5,400
Due from Ball for unrecorded returned merchandise		(5,400)	$ 5,400
Final capital balances	$ 4,940	$(4,940)	

Solution 5

Awon Co.

COMPUTATION OF INVENTORIES ON LIFO BASIS

As at December 31, 1960 and December 31, 1961

	12/31/60 inventory cost			12/31/61 inventory cost							
				Total	Valued at 12/31/60 cost			Valued at 1961 average cost			Total
	Units	Cost per pound*	Amount	units	Units	Cost	Amount	Units	Cost	Amount	amount
Iron materials:											
Raw materials	2,200,000			680,000							
Work-in-process	540,000			740,000							
Finished goods	2,460,000			2,660,000							
	5,200,000	$.02	$104,000	4,080,000	4,080,000	$.02	$ 81,600				$81,600
Iron foundry conversion costs:											
Work-in-process	540,000			740,000							
Finished goods	2,460,000			2,660,000							
	3,000,000	.06	180,000	3,400,000	3,000,000	.06	180,000	400,000	$.095	$38,000	218,000
Machine shop conversion costs:											
Work-in-process	270,000			220,000							
Finished goods	2,460,000			2,660,000							
	2,730,000	.04	109,200	2,880,000	2,730,000	.04	109,200	150,000	.07	10,500	119,700
			393,200				370,800			48,500	419,300
Purchased parts			120,000	(see schedule)			120,000			20,500	140,500
Total inventory cost on LIFO basis			$513,200				$490,800			$69,000	$559,800

*66 2/3% of seller's unit book value

Awon Co.

COMPUTATION OF AVERAGE COST OF MATERIAL PURCHASES AND COST OF PURCHASED PARTS INVENTORY

Raw material:	
Total cost of 10,480,000 lbs.	$335,360
Average cost per lb.	$.032
Purchased parts:	
Inventory valued at current costs	$210,000
Inventory valued at December 31, 1960 price level $210,000 ÷ 105%	$200,000
Inventory acquired December 31, 1960 valued at seller's cost	180,000
1961 layer at December 31, 1960 prices	$ 20,000
Cost of inventory acquired December 31, 1960 66-2/3% of $180,000	$120,000
Cost of 1961 increment $20,000 × 102½%	20,500
Total cost of purchased parts inventory December 31, 1961	$140,500

Awon Co.

COMPUTATION OF CONVERSION COSTS

For Period January 1, 1961 to December 31, 1961

		Iron foundry	*Machine shop*
Foundry conversion costs:			
Raw materials on hand January 1, 1961		2,200,000 lbs.	
Materials purchased		10,480,000	
		12,680,000	
Less—Raw materials on hand *December 31, 1961*		680,000	
Castings produced		12,000,000 lbs.	
Total 1961 conversion costs		$1,140,000	
Average cost per pound		$.095	
Machine shop conversion costs:			
Inventory of castings in process January 1, 1961: 50% of 540,000			270,000 lbs.
Castings produced in 1961			12,000,000
			12,270,000
Less—Inventory of unfinished castings December 31, 1961:			
In machining process (50% of 440,000 lbs.)	220,000		
Rough castings	300,000		520,000
Castings processed in machine shop in 1961			11,750,000 lbs.
Total machine shop conversion costs			$822,500
Average cost per pound			$.07

ACCOUNTING PRACTICE—PART II

May 17, 1962; 1:30 to 6:00 p.m.

Solution 1

(1)

Provision for product warranty		$10,000	
Estimated liability for product warranty			$10,000

To adjust current year provision for product warranty costs based on experience factor of 1½% of net sales.

Gross sales	$2,040,000
Sales returns and allowances	40,000
Net sales	2,000,000
Warranty cost experience factor	1½%
Provision for current year	30,000
Recorded provision for current year	20,000
Adjustment required	$ 10,000

(2)

Prior year adjustments		17,000	
Estimated liability for product warranty			17,000

To establish liability for product warranty at estimated requirement.

Liability balance, per books	$53,000
Adjustment #1	10,000
Total	63,000
Estimated liability required	80,000
Adjustment required	$17,000

(3)

Provision for federal income taxes		$4,000	
Accrued federal income taxes			$4,000
To adjust liability for current year's income taxes.			
Income per books	$50,000		
Add current year provision for product warranty	20,000		
Total	70,000		
Less actual claim expense	12,000		
Taxable income	$58,000		
Income tax liability for current year ($58,000 × 50%)	$29,000		
Provision recorded on the books	25,000		
Additional provision to be recorded	$ 4,000		

(4)

Deferred tax benefit*	40,000	
Provision for federal income taxes		9,000
Prior year adjustments		31,000
To record estimated future tax benefits arising from nondeductibility for income tax purposes of product warranty provisions.		

Computation of Deferred Income Taxes

Unabsorbed warranty provisions	$80,000
Current tax rate	50%
Future tax benefits arising from payment of claims charged to nondeductible liability	$40,000

Computation of Apportionment of Deferred Income Taxes

Tax effect of current year's transactions:	
Provision for product warranty on sales	$30,000
Less cost of servicing claims	12,000
Excess of deductions on income statement over deductions on tax return	$18,000
Tax effect of prior years' transactions:	
Balance of Estimated Liability for Product Warranty, January 1	$45,000
Correction of Estimated Liability for Product Warranty	17,000
Correct balance of account as of January 1	$62,000
Deferred income taxes applicable to:	
Current year (50% of $18,000)	$ 9,000
Prior years (50% of $62,000)	31,000
Deferred income taxes (50% of $80,000)	$40,000

*An alternative treatment would be to reduce the Estimated Liability for Product Warranty by $40,000 instead of establishing a Deferred Tax Benefit account.

Solution 2

a.

Lauren Corporation

COMPUTATION OF TAXABLE INCOME

For the year ended December 31, 1961

Net income per books	$ 210,000
Add:	
Federal income tax provision	200,000
Deferred lease revenues	150,000
Increase in reserve for bad debts	160,000
Amortization of investment in subsidiaries	50,000
Total	770,000
Deduct:	
Additional accelerated depreciation	1,000,000
Charges to reserve for machinery repairs in excess of provision	70,000
Total deductions	1,070,000
Tax loss before contribution limitation	300,000
Contributions in excess of 5% limitation	5,000
Tax loss for 1961	$ 295,000

b.

SCHEDULE M

Earned surplus, December 31, 1960	$ 785,000
Tax loss of 1961	(295,000)
Excess of accelerated depreciation over book depreciation	1,000,000
Charges to reserve for machinery repairs in excess of provision	70,000
Total additions to surplus	1,560,000
Capital stock distributed to stockholders	400,000
Contributions in excess of 5% limitation	5,000
Federal income tax provision	200,000
Deferred lease revenues	150,000
Increase in reserve for bad debts	160,000
Amortization of investment in subsidiaries	50,000
Total deductions from surplus	965,000
Earned surplus, December 31, 1961	$ 595,000

Computation of Earned Surplus

Earned surplus, December 31, 1960	$785,000	
Net income for 1961 per books	210,000	$995,000
Less transfer for capital stock distribution		400,000
Earned surplus, December 31, 1961		$595,000

Solution 3

a.
$$\begin{aligned} \text{Let } X &= \text{number of units} \\ 20X &= 14X + 360{,}000 + 252{,}000 \\ X &= 102{,}000 \text{ units} \\ \text{Breakeven point} &= \$20 \times 102{,}000 = \$2{,}040{,}000 \end{aligned}$$

b.
$$\begin{aligned} X &= \frac{\text{Fixed expenses + net profit}}{\text{Contribution margin per unit}} \\ &= \frac{612{,}000 + 60{,}000}{6} \\ &= 112{,}000 \text{ units} \end{aligned}$$

c.
$$\begin{aligned} 20X &= 14X + 612{,}000 + .10\,(20X) \\ & 153{,}000 \text{ units} \end{aligned}$$

d.

Flear Company

CONVENTIONAL COSTING INCOME STATEMENT

For the Year Ended December 31, 1961

Sales (150,000 @ $20)		$3,000,000
Cost of sales:		
Beginning inventory (10,000 @ $13)	$ 130,000	
Production (160,000 @ $13)	2,080,000	
Available for sale	2,210,000	
Ending inventory (20,000 @ $13)	260,000	
Standard cost of sales	1,950,000	
Add unfavorable variances:		
Variable manufacturing costs	40,000	
Volume variance (20,000 @ $2)	40,000	
Cost of sales		2,030,000
Gross profit		970,000
Selling expenses:		
Variable (150,000 @ $3)	450,000	
Fixed	252,000	
Total selling expenses		702,000
Net income		$ 268,000

Flear Company

DIRECT COSTING INCOME STATEMENT

For the Year Ended December 31, 1961

Sales (150,000 @ $20)		$3,000,000
Direct costs and expenses:		
Beginning inventory (10,000 @ $11)	$ 110,000	
Production (160,000 @ $11)	1,760,000	
Available for sale	1,870,000	
Ending inventory (20,000 @ $11)	220,000	
Standard variable cost of sales	1,650,000	
Add variance in variable production costs	40,000	
Variable manufacturing cost of sales	1,690,000	
Variable selling expense (150,000 @ $3)	450,000	
Total direct costs and expenses		2,140,000
Marginal income		860,000
Less period costs:		
Fixed factory overhead	360,000	
Fixed selling expenses	252,000	
Total period costs		612,000
Net income		$ 248,000

e.

STATEMENT ACCOUNTING FOR DIFFERENCE IN NET INCOME

Net income per conventional costing		$268,000
Net income per direct costing		248,000
Net difference		$ 20,000
Difference accounted for:		
Ending inventory (conventional costing)	$260,000	
Ending inventory (direct costing)	220,000	
Difference between ending inventories		$ 40,000
Beginning inventory (conventional costing)	130,000	
Beginning inventory (direct costing)	110,000	
Difference between beginning inventories		20,000
Net difference		$ 20,000

The $20,000 difference in net income is traceable to the methods of valuing the beginning and ending inventories. The inventories under conventional costing include an application of fixed factory overhead whereas under direct costing there is no application of fixed factory overhead. In other words, $20,000 of prior year fixed overhead was charged to the current period and $40,000 of current year fixed overhead was capitalized in inventory under conventional costing while all fixed overhead was charged to the current period under direct costing.

Solution 4

Rab Company
COMPUTATION OF INVENTORY LOSS
May 1, 1962

Cost of missing All Steel chairs = $1{,}800 \times \frac{\$5.00}{125\%} = \$7{,}200$

Cost of missing Open Seat chairs = $200 \times \frac{\$3.75}{125\%} = 600$

Total inventory loss $7,800

Computation of Tubing Missing

		Total feet
Opening inventory, Dec. 31, 1961 (see schedule)		265,000
Purchases (see schedule)		1,337,000
Total available		1,602,000
Less:		
Chairs shipped (see schedule)	1,370,000	
Scrap loss (see schedule)	3,000	
Ending inventory (see schedule)	201,600	
Total accounted for		1,574,600
Total tubing missing		27,400

Computation of Units Missing

$$\frac{\text{All Steel chairs shipped}}{\text{Open Seat chairs shipped}} = \frac{90{,}000}{10{,}000} = \frac{9}{1} = \text{ratio of sales}$$

$9 \times 14 = 126$ feet

$1 \times 11 = 11$ feet

Tubing per unit ratio of sales = 137 feet

$$\frac{27{,}400}{137} = 200 \text{ missing unit ratios of sales}$$

$9/10 \times 200 \times 10 = 1{,}800$ All Steel chairs missing

$1/10 \times 200 \times 10 = 200$ Open Seat chairs missing

Computation of Opening Inventory

	Units	Feet of Tubing per Unit	Total Feet
Raw materials:			
72" lengths	13,500	6	81,000
Random mill lengths	—	9,800	9,800
Work-in-process:			
Individual legs	2,900	2	5,800
All Steel chair frames	1,300	6	7,800
Open Seat chair frames	300	3	900
Finished goods:			
All Steel chairs	10,700	14	149,800
Open Seat chairs	900	11	9,900
Total opening inventory			265,000

Computation of Purchases

72" lengths	202,000	6	1,212,000
Random mill lengths	—	125,000	125,000
Total purchases			1,337,000

Computation of Chairs Shipped

All Steel	90,000	14	1,260,000
Open Seat	10,000	11	110,000
Total chairs shipped			1,370,000

Computation of Scrap Loss—Random Mill Lengths

Opening inventory	9,800
Purchases	125,000
Total available	134,800
Ending inventory	34,800
Total consumed	100,000
Scrap loss @ 3%	3,000

Computation of Ending Inventory

Raw materials:			
72" lengths	8,500	6	51,000
Random mill lengths	—	34,800	34,800
Work-in-process:			
Individual legs	9,700	2	19,400
All Steel chair frames	800	6	4,800
Open Seat chair frames	100	3	300
Finished goods:			
All Steel chairs	5,500	14	77,000
Open Seat chairs	1,300	11	14,300
Total ending inventory			201,600

Solution 5

a.

City of Bruceville

ADJUSTING ENTRIES*

December 31, 1961

(1)

Reserve for supplies inventory	$ 2,000	
Unappropriated surplus		$ 2,000

To reduce reserve to $10,000, the amount of the physical inventory at 12/31/61.

*An optional entry may be made to transfer $10,000 of the five departments' appropriation to the Unencumbered Appropriations—1961 account.

b.

CLOSING ENTRIES

(1)

Reserve for encumbrances	$7,000	
Unappropriated surplus	100	
Expenditures chargeable against prior years' encumbrances		$7,100
To close opening balance in Reserve for Encumbrances and related Expenditures account.		

(2)

Revenue-miscellaneous	19,900	
Unappropriated surplus	100	
Estimated revenue-miscellaneous		20,000
To close miscellaneous revenue accounts.		

(3)

Revenue-taxes	95,500	
Unappropriated surplus		500
Estimated revenue-taxes		95,000
To close tax revenue accounts.		

(4)

Appropriations	102,000	
Unappropriated surplus		2,000
Encumbrances		20,000
Expenditures		80,000
To close appropriations, expenditures and encumbrances of 1961.		

(5)

Surplus receipts	1,700	
Unappropriated surplus		1,700
To close surplus receipts.		

City of Bruceville
GENERAL FUND—UNAPPROPRIATED SURPLUS ACCOUNT

(Not required)

Appropriations	$112,000	Balance, 1/1/61	$ 300
Balance, 12/31/61, before adjusting and closing entries	3,300	Estimated revenues — miscellaneous	20,000
		Estimated revenues — taxes	95,000
	$115,300		$115,300
Excess of estimated miscellaneous revenue over actual	$ 100	Balance, 12/31/61, before adjusting and closing entries	$ 3,300
Excess of prior years' expenditures over encumbrances	100	Reserve for supplies inventory	2,000
		Excess of actual tax revenue over estimated revenue	500
		Excess of appropriations closed out over expenditures and encumbrances	2,000
12/31/61—Final balance	9,300	Surplus receipts	1,700
Total	$ 9,500	Total	$ 9,500
		12/31/61—Final balance	$ 9,300

c.

City of Bruceville

ANALYSIS OF CHANGES IN UNAPPROPRIATED SURPLUS

For Year Ended December 31, 1961

	Estimated	*Actual*	*Excess or Deficiency* of Actual Compared with Estimated*
Balance, 1/1/61	$ 300	$ 300	
Add:			
Reserve for encumbrances, 1/1/61	7,000	7,000	
Revenue:			
Miscellaneous	20,000	19,900	$ 100*
Taxes	95,000	95,500	500
Total revenue	115,000	115,400	400
Restoration of reserve for supplies inventory		2,000	2,000
Surplus receipts		1,700	1,700
Total additions	122,000	126,100	4,100
Total	122,300	126,400	4,100
Deduct:			
Expenditures	112,000	80,000	32,000
Encumbrances, 12/31/61		20,000	20,000*
Total	112,000	100,000	12,000
Unencumbered appropriations transferred to 1962		10,000	10,000*
Expenditures chargeable to prior years' encumbrances	7,000	7,100	100*
Total deductions	119,000	117,100	1,900
Balance, 12/31/61	$ 3,300	$ 9,300	$ 6,000

Solution 6

a.

J-P Bowling Company

COMPUTATION OF AMOUNT WHICH MAY BE PAID AS CASH DIVIDENDS IN 1962

1.

Working Capital Restrictions

Current assets	$16,787,000
Current liabilities	8,290,000
Working capital	8,497,000
Minimum working capital	6,500,000
Available for cash dividends	$ 1,997,000

2.

1960 Net Income Limitation

Net income for 1960		$507,000
Cash dividends paid in 1960	$ 98,000	
Cash dividends paid in 1961 (24.4% of $507,000 therefore 25% limitation does not apply)	124,000	
Total cash dividends		222,000
1960 earnings not distributed		$285,000

No limitation is imposed by restrictions on 1960 earnings because cash dividends were not in excess of restrictions. Stock dividends are not subject to restrictions.

3.

1961 Net Income Limitation

1961 net income	$522,000
Limitation percentage	25%
1961 net income available for cash dividends in 1962 under percent limitation	$130,500

4.

Dividend Per Share Limitation

Total capital stock par value	$3,131,000
Divided by par value per share	50
Number of shares outstanding	62,620
Dividend limitation per share	2
Total dividend limitation	$ 125,240

5. Inasmuch as no cash dividends were paid in excess of restrictions, no limitation on subsequent years' earnings is required.

The amount of cash dividends which may be paid under the loan agreement in 1962 is $125,240.

b.

COMPUTATION OF ADDITIONAL LONG-TERM DEBT WHICH MAY BE INCURRED

	Year	Annual Rent Obligation	Present Value Factor	Capitalized Rent
	1962	$40,000	.952	$ 38,080
	1963	50,000	.907	45,350
	1964	50,000	.864	43,200
	1965	50,000	.823	41,150
Total "Capitalized Rent"				167,780
Note payable to bank				2,000,000
Total long-term debt outstanding, as defined				$2,167,780

The additional amount of long-term debt which may be incurred can be determined by algebra as follows:

Net Tangible Assets (NTA) plus Additional Long-Term Debt (ALTD)

equals

Ratio (R) times the sum of Long-Term Debt (LTD) plus Additional Long-Term Debt (ALTD)

or

NTA + ALTD	=	R (LTD + ALTD)
$5,300,000 + ALTD	=	2.25 ($2,167,780 + ALTD)
Maximum additional long-term debt which may be incurred	=	$337,996

AUDITING

May 17, 1962; 8:30 a.m. to 12:00 m.

Solution 1

a. (1) Under the existing circumstances the auditor would be required to exercise professional discretion to avoid offending or reflecting on the integrity of the treasurer. Wherever possible, the auditor should seek confirmation or substantiation from officials other than the treasurer. For example, it might be possible to have another college official sign the confirmation requests and, at the bank, see a bank official other than the president for confirmation of the cash balances and securities held. A particularly important audit procedure would be a surprise count of the safe deposit box. Expansion of audit procedures might be necessary for areas where internal control is weak because of the dual functions of the treasurer.

(2) An unqualified opinion can be rendered if the auditor is satisfied as to the fairness of the college's financial statements. There is no reason to comment in the report that the treasurer is the banker. However, if the auditor's examination discloses specific circumstances suggesting the existence of fraud, it is the auditor's responsibility to discuss the matter with proper officials of the college.

b. (1) The CPA may render a report and unqualified opinion under these conditions if he considers himself, in fact, to be independent. Of course, the CPA must conduct an audit, appropriate under the circumstances, to satisfy himself as to the fairness of the financial statements. The examination should preferably be conducted by staff members who did not do the original accounting work.

According to the rules of the SEC the accountant would be considered in such circumstances to be not independent.

(2) The performance of these services does not necessarily mean that the CPA is lacking in independence. Therefore, disclosure of these services is not necessary if the CPA is independent, although disclosure is frequently made.

Solution 2

a. (1) As to that portion of the inventory previously taken:

1. Secure a copy of the client's inventory instructions for taking the physical inventories and review as to completeness and adequacy.
2. Test-check the perpetual inventory cards for arithmetic accuracy.
3. From the consumed file test-check to the perpetual inventory cards a few "B" part tags stamped with dates of use subsequent to the date of taking the physical inventory.
4. Compare a representative number of perpetual inventory cards and "B" part tags of unused coils for agreement.

5. Select a representative sample of the "B" part tags of unused coils and locate the coils in the plant. Compare the information on both parts of the tags.
6. Prepare a test count list of coils in the plant and compare with the file of "B" part tags of unused coils.
7. Test-check the information on the "A" tags by having some coils weighed and by measuring the gauge and width of the coils.
8. Be alert for damaged or partly-consumed coils and discuss with company personnel the proper weight to be used for these coils.
9. Determine that a proper cutoff of purchases and issues was obtained when the client compared physical inventories with perpetual records.
10. Review the adjustments made as a result of the client's taking the physical inventory. Obtain an explanation for any adjustments of large quantities.
11. Test check receipts by comparing receiving reports with perpetual inventory cards. Also, test check issues by comparing perpetual inventory cards with production reports.

(2) As to the portion not previously inventoried:
1. Obtain a copy of the inventory instructions and review as to completeness and adequacy.
2. Observe one or two of the monthly physical inventories and ascertain that inventory instructions are being followed.
3. Prepare a list of coils which were test-counted, and compare the list with the "B" part tags in the unused coil file.
4. Prepare a detailed list of a representative number of "B" part tags in the unused coil file and locate the coils in the plant. Compare the information on both parts of the tags.
5. Determine that a proper cutoff of purchases and issues was obtained at each inventory date.

b. No deviation from the short-form accountant's certificate will be necessary. Although the auditor was unable to observe a complete physical inventory, the internal control is good and perpetual records are maintained so that he can test the physical quantities at any date. When perpetual records exist, a complete physical inventory is not usually observed; in such a case the auditor's tests are intended to establish the credibility of the amounts shown by the inventory records at the balance sheet date. His tests of quantities on hand may be combined with the observation of the client's physical inventory, but when internal control is good they may consist only of the testing of physical quantities against inventory records.

Solution 3

a. 1. The disadvantages of the Company's procedures for scrap sales are as follows:
(a) There is no accounting control of scrap sales. Scrap sales for any period should be readily determinable for comparison with prior periods.

(b) The procedure results in a difference between book and physical inventories.

2. The disadvantages of the Company's procedures for returnable spools are as follows:
   (a) The investment in returnable spools is not readily available for management guidance, and verification of the investment would require extensive audit work.
   (b) It would be difficult to ascertain that a credit has been received from the manufacturer for all credit memoranda issued by the Jones Co. to its customers.
   (c) The book inventory will be incorrect if credits to customers are not cleared by related credits from the manufacturer. Furthermore, since the spools are not salable merchandise of the Jones Co., it is improper to consider them as inventory.

b. 1. An account for scrap sales should be established to record the revenues from the sale of scrap. Thus the amount of scrap sales for any period would be readily available for review and comparison with prior periods to determine that revenues are not being diverted or that excessive scrap is not being generated through carelessness. If the revenue from scrap sales is significant, it could be treated as a reduction of costs rather than as miscellaneous income.

2. The deposits on returnable spools should not be recorded as sales but should be credited to an account such as "Allowance for Returnable Spools." This special account should be debited and accounts receivable credited when spools are returned.

   In like manner, deposits paid by Jones Co. on returnable spools should be posted to "Deposits on Returnable Spools" to exclude the amounts from purchases. When the spools are returned, the resulting credit should be used to reduce the account.

   When the Jones Co. customer returns spools directly to the manufacturer, the issuance of the customer's credit memorandum should be delayed until receipt of a credit memorandum from the manufacturer. This procedure would avoid the issuance of credit memoranda without related credit memoranda being received.

c. 1. Internal control for scrap sales would include the following procedures in addition to the changes in accounting procedures.
   (a) Accurate production records should be maintained if scrap arises from a processing operation and comparisons of scrap and production tonnages made periodically to determine that the ratio is remaining constant.
   (b) Scrap should be stored in a safe area to avoid pilferage.
   (c) Competitive bids for scrap to be sold should be obtained from reliable scrap dealers. The sale should be authorized by the proper authority and shipping documents should be prepared.
   (d) Cash received from scrap sales should be remitted directly to the cashier.

2. Internal control for returnable spools would include the following procedures in addition to the changes in accounting procedures.
   (a) An accurate perpetual inventory record of all spools on hand should be maintained.
   (b) If feasible, a perpetual record of shipments of spools to individual customers and of returns should be maintained.
   (c) The Jones Co. should take a periodic inventory of returnable spools on hand and should estimate the quantity which will be returned by customers. A comparison of the sum of these two quantities with the recorded quantities will provide a basis for writing off spools that will not be returned. If there is a difference between the amount of deposits paid to the manufacturer and charged to the customers, the difference should be recorded in an appropriate income account.

Solution 4

a. The financial statement adjustments to be suggested would include:
   1. An apportionment of the mortgage payable, $4,800 to current liabilities and $38,400 to long-term liabilities, to set out the amount of the mortgage payable in the current year.
   2. The transfer of $40,000 from Retained Earnings to Capital Contributed in Excess of Par Value of Common Stock.
   3. Officer's salary should be shown as a separate item in the income statement.

b. **Robert Corporation**
NOTES TO FINANCIAL STATEMENTS
December 31, 1961

Note 1. (Referenced to Account Receivable and Sales)
The Company manufactures one product which is sold to a single customer. The Company and the single customer are controlled by the same financial interests.

Note 2. (Referenced to Inventory)
Inventory is stated at the lower of cost (average cost) or market.

Note 3. (Referenced to Fixed Assets and Mortgage Payable)
The mortgage payable is the balance due on a ten-year, 5%, mortgage which was granted on January 1, 1961 in the amount of $48,000. The mortgage is secured by liens on the land, building, machinery and equipment owned by the Company.

Note 4. (Referenced to Fixed Assets)
Depreciation is computed on the straight-line method. The depreciation reported in the financial statements is based upon the appraised values of the assets. (Accounting authorities are not in agreement on the need to disclose the method of depreciation. It is argued that disclosure of the method of depreciation should be made in the early years of the asset's useful life because the depreciation charge under an accelerated method might be materially larger than under the straight-line method. On the other hand it is maintained that dis-

closure of the depreciation method is usually meaningless because the assets might be of varying ages, more than one method of depreciation might be in use and the assets might be continually being replaced. Therefore the need for disclosure of the method of depreciation would have to be ascertained by the CPA conducting the audit.)

c. To the Board of Directors:

Because of the circumstances set forth in Note 1 to the financial statements we cannot express an opinion as to whether the accompanying income statement fairly presents the results of operations for the year ended December 31, 1961. However, in our opinion, the accompanying balance sheet presents fairly the financial position of the Company at December 31, 1961 in conformity with generally accepted accounting principles.

Reason for disclaimer:

Prospective investors or creditors would be misled by the income statement because it is not a reliable indication of the Company's earning capacity or probable future. The statement is unreliable because the results of its operations are subject to the decisions of the principal stockholder who can determine selling prices and, within limits, sales volume. Sales prices are not established by arms-length bargaining as is the case in an open market, nor is sales volume determined by demand, the persuasiveness of an independent sales force, or by productive capacity. The absence of these independent factors materially reduces the meaningfulness of the income statement.

Apparently the auditor would be in a position to give an opinion on combined statements of the two Companies. Perhaps such statements should be suggested to the client.

Solution 5

Gaar Corporation
ADJUSTING JOURNAL ENTRIES
December 31, 1961

(1)		
Depreciation expense-building	$ 200.00	
Allowance for depreciation-building		$ 200.00
To record one-half year's depreciation on old boiler. ($10,000 × 4% × ½)		
(2)		
Building	2,000.00	
Gain or loss on disposition of fixed assets		2,000.00
To correct the recording of insurance recovery.		
(3)		
Purchases discount	274.40	
Fuel expense	824.00	
Allowance for depreciation-building	6,200.00	
Gain or loss on disposition of fixed assets	2,320.00	
Building		9,618.40
To correct the recording of the purchase of the new boiler and the trade-in of the old.		

Computation of Fuel Expense

Fuel oil included in invoice price of new boiler (5,000 gals. @ 16¢)	$ 800.00
Sales tax @ 3%	24.00
Fuel expense	$ 824.00

Computation of Allowance for Depreciation-Building

$10,000 × 4% × 15½ years = $6,200.00

Computation of Gain or Loss on Disposition of Fixed Assets

Cost of old boiler	$10,000.00
Allowance for depreciation	6,200.00
Book value at time of explosion	3,800.00
Less trade-in allowance	1,480.00
Tentative loss on disposition	$ 2,320.00

Computation of Cash Discount on Purchase of Boiler

Invoice price		$16,000.00
Less:		
Fuel oil included in invoice price	$ 800.00	
Trade-in allowance	1,480.00	2,280.00
		$13,720.00
Purchases discount @ 2%		$ 274.40

(4)

Building	1,000.00	
Repair expense		1,000.00

To correct the recording of the cost of installation of the boiler.

(5)

Depreciation expense-building	22.19	
Allowance for depreciation-building		22.19

To correct recorded depreciation expense on the building and the new boiler.

Cost of building	$100,000.00	
Less cost of old boiler (depreciation recorded in entry #1)	10,000.00	
Cost subject to full year depreciation	$ 90,000.00	
Depreciation @ 4%		$ 3,600.00
Cost of new boiler	$ 16,381.60	
Depreciation on new boiler ($16,381.60 ÷ 9½ × ½)		862.19
(New boiler is depreciated over remaining life of the building.)		
Total adjusted depreciation		4,462.19
Depreciation recorded		4,440.00
Depreciation adjustment required		$ 22.19

Cost of New Boiler

Invoice price		$16,000.00
Less fuel oil		800.00
Remainder		15,200.00
Add:		
Sales tax	$ 456.00	
Installation	1,000.00	1,456.00
Total		16,656.00
Less cash discount		274.40
Cost of new boiler		$16,381.60

Solution 6

a. (1) The function of the auditor in the examination of financial statements is to provide users of the statements with an informed opinion as to the fairness with which the statements portray financial position and the results of operations in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

(2) The responsibility of the independent auditor is confined to his professional opinion on the financial statements he has examined. Inasmuch as the statements are the representations of management, responsibility rests with management for the proper recording of transactions in books of account, for the safeguarding of assets and for the substantial accuracy and adequacy of the financial statements.

In developing the basis for his opinion he is responsible for making an examination which conforms to generally accepted auditing standards. These standards constitute the measure of the adequacy of his examination.

He must use judgment in selecting the procedures he uses in his examination and in arriving at his opinion. The informed judgment of a qualified professional accountant is required of him.

In holding himself out to the public as an independent auditor he makes himself responsible for having the abilities expected of a qualified person in that profession. Such qualifications do not include those of an appraiser, valuer, expert in materials, expert in styles, insurer, or lawyer. He is entitled to rely upon the judgment of experts in these other areas of knowledge and skill.

b. Although the independent auditor's examination is not designed, nor can it be relied upon, to uncover defalcations and similar irregularities, they may be discovered because he is continually aware that any fraud of material amount would affect his opinion on the fairness of the presentation of the financial statements. Therefore the auditor's examination gives consideration to the possible existence of fraud. However, failure to detect fraud is the responsibility of the independent auditor only when such failure clearly results from noncompliance with generally accepted auditing standards.

An adequate accounting system with appropriate internal control should be the principal means of thwarting and detecting fraud. To rely upon an independent auditor's examination for the detection of fraud would require expanding his work to the extent that the cost might be prohibitive. Moreover, his examination might not uncover certain types of fraud involving unrecorded transactions, forgeries or collusion. Good internal control and fidelity bonds probably supply the more effective and economic safeguards against fraud.

The independent auditor is not an insurer or guarantor. His implicit obligation in an engagement is that his examination be made with due professional skill and care in accordance with generally accepted auditing standards. That fraud, existent during the period covered by the independent auditor's examination, was discovered later, does not of itself indicate negligence on his part.

c. If the independent auditor's examination uncovers circumstances arousing suspicion as to the existence of fraud, he should weigh its effect on his opinion on the financial statements. When he believes the amount of the possible fraud is not large enough to affect his opinion, he need only refer the matter to the client for investigation. If he believes the amount of the possible fraud is so material as to affect his opinion, the matter must be investigated before an opinion is given. The client should decide, in discussion with the auditor, whether the client or the auditor will conduct the investigation. If the client elects to conduct it, the auditor will review the matter and evaluate the effect of the findings on the statements and on his opinion.

Solution 7

a. Pro forma financial statements are special purpose financial statements reporting the effect of transactions consummated or which may be consummated subsequent to the date of the statements.

b. The following conditions are necessary for giving an opinion on pro forma financial statements:

   1. The subsequent transactions reported in the statements are the subject of a definite (preferably written) contract or agreement. In the absence of a definite agreement there is no auditing evidence to support the auditor's opinion regarding the statements. Moreover, there must be assurance that transactions would be consummated in accordance with a definite plan so that the results can be logically determined.

      Certification of pro forma statements is denied when they include an estimate of earnings contingent upon future operations. Forecasts based upon subsequent events beyond the normal control of business management are subject to varying degrees of reliability. To vouch for the accuracy of such a forecast is unethical.

   2. The accountant must be satisfied that the involved parties are responsible and able to carry out the provisions of the agreement. Even though the statements were based upon a formal agreement, they would be misleading if the parties did not have the ability or the intention to carry out the agreement.

   3. The time elapsing between the date of the statements and the contemplated date of the subsequent transactions should be reasonably short—not

more than, say, four months. If a longer time elapses there is increased likelihood of major changes in financial condition because of operating results. Furthermore, other post-balance-sheet-date events might occur to impair the reliability of the statements.

4. Investigation and inquiry should disclose that no other transactions or developments had occurred that would adversely affect the position of the company. This post-balance-sheet-date review should be carried through the date of the completion of the audit field work. Events of material importance occurring after the date of the financial statements must be reported by adjustment or annotation to prevent the statements from being misleading.
5. The character or purpose of the transaction to which effect is given should be disclosed in the statement heading or elsewhere in the report. Such disclosure would prevent the statements from being misleading.
6. It is desirable to use the past tense in any description of a statement and in a related auditor's report. Using the past tense is an additional device to make clear that the contemplated (or consummated) transactions have been definitely covered by contracts and are not forecasts or estimates based upon impending events.

Solution 8

a. 1. Population refers to all the items in a group under study.
   2. Sample is defined as the items selected from a population, generally for the purpose of estimating some characteristic of the population.
   3. Precision is the extent to which a sample estimate may deviate from the true characteristic present in a population.
   4. Confidence is the probability, usually expressed as a percentage, that a sample estimate will fall within the precision represented by a stated range about the true value or proportion present in a population or, commonly, the percentage of times that a correct decision (that is, within the precision limits specified) will result when reaching a conclusion based on a sample drawn from a given population.

b. The correct sample size is 454. The principal factor involved in attaining a specified precision and confidence is the absolute size of the sample. The size of the population from which it is drawn does, however, have a slight effect on the necessary sample size, so the sample should be larger than 436, but it would increase substantially less than in direct proportion to the increase in population. Therefore 4,360 and 3,000 are ruled out.

c. Modern auditing is based on the principle of test-checking and evaluating a population on the basis of the sample. An experienced auditor is expected to have developed the professional judgment necessary to make satisfactory evaluations. The value of statistical techniques lies in the quantification of the risks involved. It is very helpful to know the percent of risk—25%, 5%, 1%, or some other figure—of reaching a wrong conclusion based on analysis of a sample. Statistical techniques provide the auditor with a tool to assist him in deciding whether a conclusion based on a given sample is sufficiently reliable to warrant its acceptance.

COMMERCIAL LAW

May 18, 1962; 8:30 a.m. to 12:00 m.

Solution 1

1. False	16. False	31. True	46. True	61. False
2. True	17. True	32. False	47. False	62. True
3. True	18. True	33. False	48. False	63. False
4. False	19. False	34. True	49. True	64. False
5. False	20. False	35. True	50. False	65. False
6. True	21. True	36. True	51. False	66. True
7. True	22. True	37. True	52. False	67. True
8. True	23. True	38. False	53. True	68. False
9. False	24. False	39. True	54. False	69. False
10. False	25. False	40. False	55. False	70. True
11. True	26. False	41. False	56. False	71. True
12. False	27. False	42. False	57. True	72. True
13. False	28. True	43. False	58. True	73. True
14. True	29. True	44. False	59. True	74. False
15. False	30. False	45. True	60. True	75. True

Solution 2

76. True	91. False	106. False	121. False	136. False
77. True	92. False	107. True	122. False	137. True
78. True	93. True	108. True	123. True	138. False
79. True	94. True	109. False	124. True	139. True
80. False	95. False	110. False	125. False	140. False
81. True	96. False	111. True	126. False	141. True
82. True	97. True	112. True	127. True	142. False
83. True	98. True	113. False	128. True	143. True
84. True	99. True	114. False	129. True	144. True
85. False	100. True	115. False	130. True	145. False
86. False	101. True	116. False	131. False	146. False
87. True	102. True	117. False	132. True	147. False
88. True	103. True	118. False	133. True	148. False
89. False	104. True	119. True	134. True	149. True
90. False	105. False	120. True	135. False	150. False

Solution 3

151. True	166. True	181. True	196. False	211. False
152. True	167. False	182. False	197. True	212. False
153. True	168. True	183. True	198. True	213. False
154. False	169. True	184. False	199. True	214. False
155. False	170. False	185. False	200. True	215. True
156. False	171. False	186. True	201. False	216. True
157. False	172. True	187. True	202. False	217. True
158. True	173. False	188. False	203. True	218. False
159. True	174. True	189. False	204. False	219. True
160. False	175. False	190. False	205. False	220. False
161. True	176. True	191. False	206. False	221. True
162. True	177. True	192. False	207. False	222. True
163. True	178. False	193. False	208. True	223. True
164. True	179. True	194. True	209. False	224. True
165. False	180. False	195. False	210. False	225. False

Solution 4

a. 1. Yes. A noncompensated surety is released when there is modification of the terms of the contract without his consent. The release is in no way affected by the attempt by the creditor to assert the original obligation.
   2. Yes. The Statute of Frauds states that a contract by an obligee to answer for the debt, default or miscarriage of another, i.e., a contract of surety (or guaranty), is unenforceable unless it is in writing or there is a written memorandum thereof signed by the party to be charged. Since Stanley's promise was oral it is not legally enforceable.

b. The cosurety may assert the right of:
   1. Reimbursement. The cosurety who has performed the obligation owed by the principal debtor has the right to be reimbursed by the principal debtor for his reasonable outlay. For example, if the cosurety pays a $100 debt of the principal debtor plus interest of $5, he has a right to be repaid $105 by the principal debtor.
   2. Subrogation. The cosurety may assert the right of subrogation, i.e., to succeed to the rights of the creditor. This may be a valuable right when the creditor has security or where the creditor would be entitled to some preference. For example, if the creditor has a chattel mortgage securing the performance of the principal debtor, the cosurety could assert the creditor's rights, i.e., foreclose, to compensate himself for his outlay.
   3. Contribution. The cosurety who in the performance of his own obligation discharges more than his proportionate share of the principal's duty is entitled to contribution from his cosurety. For example, if S and CS are cosureties to the extent of $100 each on the $100 debt of P, and S pays the creditor the $100, he would have a right of contribution of $50 from CS.

Solution 5

a. 1. An actual eviction is a physical ousting of the tenant from possession of all or part of the premises by the landlord or his agent. A constructive eviction is a nonphysical ousting by the landlord or his agent by means of some act or condition which he controls or permits to exist and which makes continued occupancy difficult or unpleasant. To claim a constructive eviction the tenant must promptly quit the premises.
   2. Yes. The electricity and heat were clearly within the landlord's control and he was using them in such a manner as to make occupancy of the apartment unpleasant, if not unbearable. There has been a prompt abandonment which is a requirement necessary to constitute a constructive eviction.

b. 1. The difference between an assignment and a sublease is that in an assignment the tenant transfers his entire interest in the leased property; whereas, in a sublease the tenant transfers only part of his interest while retaining some part for himself. In addition, in a sublease there is an additional landlord-tenant relationship created between the sublessor and the sublessee.
   2. Yes. The prohibition in the lease of the right to sublet does not impliedly negate the right of assignment. In order to prohibit both rights they must be separately negated by express language in the lease.

c. 1. Henry as a holdover tenant is occupying the premises under a tenancy by sufferance.
   2. The landlord has the following optional remedies:
      (a) Treat the tenant as a trespasser. Some jurisdictions require the giving of notice and waiting a prescribed period of time before the tenant can be treated as a trespasser.
      (b) Sue the tenant for damages and remove him by legal process.
      (c) Treat the tenant as obligated for an additional year's rent, according to the terms of the prior lease.

Solution 6

a. No as to Peter. Yes as to Allen. Although Peter may disaffirm the contract based upon his minority, Allen is nevertheless liable thereon. An agent making a contract for a principal whose contracts are voidable because of lack of capacity is liable if he has reason to know of the principal's lack of capacity and the other party's ignorance thereof. He has, in effect, impliedly warranted his principal's capacity. In this case Allen knew of Peter's minority and of Tom's ignorance of this fact. Neither the exhibition of the written authority nor the clear indication of the agency relationship will free Allen from liability.

b. Yes. Ace Television can recover $450. Stephen's authority was expressly limited to the collection of the 10% down payment. The additional payment is not binding upon the principal because the agent had no express or apparent authority for the receipt of such payment.

c. Yes. The death of the principal immediately terminated the authority of the agent without notice to him. Both express and apparent authority terminate with the death of the principal; third persons who, in ignorance of the death, deal with the former agents have neither any rights nor any liabilities insofar as the deceased, or the estate of the deceased, is concerned.

d. The undisclosed principal is not liable for contracts made by his agent even though he is acting within the scope of his authority if:
   1. The contract specifically excludes the principal.
   2. The contract is a negotiable instrument.
   3. The contract is a sealed instrument and the common law rule as to sealed instruments has not been abrogated.
   4. The contract has been fully executed by the agent.

Solution 7

a. 1. No. Roger is a nonassuming grantee in that he did not promise to pay the debt but instead merely bought the land which was subject to the mortgage. Even if he were actually aware of the mortgage and bond he would still have no personal liability, in the absence of an express assumption of the debt.
   2. Yes. Upon default in payment the bank can proceed on either the bond (promise to pay) or the mortgage. Since Jack has disappeared, the bank should foreclose the mortgage in full or partial satisfaction of the debt. The foreclosure will result in a judgment which directs that the property be sold to satisfy the debt.
   3. The bank's rights will be superior to Roger's rights. Although Roger acted in good faith and did not have actual notice of the bank's interest, he had constructive notice via the recordation. This constructive notice is sufficient to entitle the bank to first claim against the property to satisfy the debt.
   4. No. Roger would not be entitled to take title free of the bank's mortgage because he had actual notice. This notice will prevent him from becoming a *bona fide* purchaser. The fact that the mortgage was not recorded is immaterial.
   5. An equity of redemption is the right of the mortgagor to redeem the property after it has been forfeited at law (normally due to breach of the condition requiring payment on the due date) upon payment of the debt, interest and costs. The right of redemption can be cut off by a foreclosure as discussed above unless by statute it may be exercised within a stated period following foreclosure and sale.

b. 1. Hostile to the owner and with an intent to claim title to the property. The occupant must be upon the land in a nonpermissive capacity and he must intend to claim the land as his own. The good faith of the occupant is immaterial, i.e., he may mature his title without any rightful claim.
   2. Actual. The occupant must be physically present upon the land. He cannot obtain title by merely posting signs, giving notice, or paying taxes.
   3. Open and notorious. The occupation must be such that it is or should be

readily apparent to the owner that another is upon his land. A showing that the owner was actually aware of the occupancy is not necessary.
4. Exclusive. The occupant must assert the rights of an owner and as such must prevent others from trespassing upon the land.
5. Continuous for a prescribed period of years. In reality, this represents a fulfillment of the requisite period set forth in the local statute of limitations. After this period has elapsed a suit can no longer be brought by the real owner against the adverse occupant. The requirement of continuity prevents the adverse occupant from occupying the land for several short periods, broken by abandonment, and adding these periods to fulfill the prescribed period.

Solution 8

a. 1. No. The requirement of privity of contract would prevent Norman from recovering against the manufacturer. Significant inroads in the privity doctrine have been made by the courts, and sometimes by the legislature, in the food and drug area. However, despite these significant exceptions, the privity of contract requirement is the majority rule.
2. Yes. From the facts it appears that the manufacturer was negligent in using the random sampling technique instead of testing all rungs. Although the custom of the industry is not conclusive as to the standard of care that should be exercised it is a strong factor to be considered. Privity of contract is not necessary to recover for physical harm resulting from the negligence of a manufacturer of a product which, if defective, would be dangerous.

b. The publisher will argue that the parties intended a sale or return. Under this type of sales transaction title passes to the buyer immediately, and the risk of loss as the result of an inadvertent or accidental destruction rests with the buyer. Under a sale on approval title does not pass to the buyer until he has indicated approval, and the risk of loss remains with the seller.

c. 1. A bulk sale is the sale, which is not in the ordinary course of the seller's business, of the whole of a stock of merchandise, of any part of a stock of merchandise, or of the fixtures of a business.
2. The statutes were adopted to protect the creditors of the bulk seller.
3. The evil at which the statutes were directed was the secret and rapid liquidation by the debtor of the inventory sold to him on credit, usually followed by his fleeing the jurisdiction.
4. The transaction is void as against the seller's creditors. The bulk purchaser will hold the property, or the proceeds from the sale of the property, acquired from the bulk seller, in trust for the benefit of the bulk seller's creditors.

THEORY OF ACCOUNTS

May 18, 1962; 1:30 p.m. to 5:00 p.m.

Solution 1

1. c
2. d
3. b
4. c
5. d
6. a
7. c
8. d
9. c
10. b

Solution 2

1.	Bonds Payable	d, h, j
2.	Reserve for Encumbrances	a, b, c, d
3.	Matured Bonds Payable	a, b, e
4.	Bonds Authorized—Unissued	c
5.	Equipment	f, g, h, i
6.	Appropriations	a, b, c, d
7.	Estimated Revenues	a, b
8.	Taxes Receivable—Current	a, b, e
9.	Interest Payable in Future Years	j
10.	Contracts Payable—Retained Percentage	c, d, h

Solution 3

a. Dividends may be declared payable in forms other than cash, such as inventory, investments or other property. The dividend, however, must be divided ratably among the participating stockholders.

A corporation does not realize profit or loss upon distribution of assets in the form of dividends to stockholders. From the standpoint of the declaring corporation the assets' net book value should be the amount by which retained earnings is reduced as a result of the dividend. Because the amount of retained earnings is directly related to the book value of net assets, it follows that a property dividend or other distribution of assets must be recorded in retained earnings as the valuation appearing in the books.

The foregoing does not imply that the dividend cannot be recorded at its market value. Recording the dividend at market value might be desirable to permit future comparisons of dividend rates or if cash must be distributed to small stockholders in lieu of fractional shares of June Corporation stock. It is especially important when more than one class of stock exists and the property distribution is to a class other than common stock. Preferred stockholders should not profit by property dividends, the market value of which exceeds the fixed dividend rate.

The market value can be recognized in the accounts by adjusting the asset account and establishing an appreciation capital account. When the distribution is made, the appreciation account will be cancelled and the net charge to retained earnings would be the original book value of the assets being distributed.

Before the increase in market value of the assets is recorded, consideration should be given to the uniformity of the balance sheet presentation of any assets remaining after the distribution. For example, if part of the June Corporation stock was not distributed and May Corporation had other stock investments, the investment account would not uniformly present all investments. Another consideration is the legality of dividends declared from capital arising from an appraisal increment. State laws are not consistent in this area.

b. The wording of the declaration of a property dividend is of special significance. If the declaration states that corporate property is being distributed as a dividend, the dividend liability is the net book value of the property distributed. But if the declaration states the property is in payment of the dividend liability, the liability may be more or less than the book value of the property which is to be distributed.

Regardless of the wording of the declaration the stockholders should record as income the fair market value of the property received. Therefore they should be fully advised of the details of the dividend and be given the fair market value.

Solution 4

(1) A quasi-reorganization is a readjustment under which the corporation has a "fresh start" from an accounting standpoint. The objective of a quasi-reorganization might be to eliminate a deficit from the books. Another objective might be to write down asset amounts from original values to amounts which are realistic under existing economic conditions. It is possible to combine both objectives in the same quasi-reorganization. Although the accounts are stated as though a new corporation has been formed, there is no disturbance of the existing corporate entity.

Any material write-down of asset values should be made first to retained earnings. If retained earnings are exhausted by the write-down or if a deficit is being written off, paid-in capital should be used to absorb the amounts. When paid-in capital is depleted, capital stock may be written down if state legal restrictions permit.

When the quasi-reorganization is completed, no deficit should exist in any capital account and assets should be valued at fair but not unduly conservative amounts. Unreasonable write-downs of asset values would cause distortion of the balance sheet and excessive reported income through understatement of depreciation. Furthermore, if any previously accumulated retained earnings exist after such adjustments, they are usually carried forward as a form of contributed capital subject to the restrictions for such initial capital.

The computation of depreciation on an historical cost basis for income tax purposes and on revised values for statement purposes would frequently result in taxable income lower than book income. Therefore the provision for income taxes on the statements of the quasi-reorganized company would be less than the provision made by nonreorganized companies.

(2) The purpose of eliminating the deficit is to relieve the company from the handicap of past losses which result in an unfavorable reporting of current financial position. Assets would be written down and depreciation computed on realistic values to avoid misstating current operating results by depreciation based on former price levels. Use of the quasi-reorganization procedure by a corporation may be proper if these conditions exist.

(3) When management has decided that a quasi-reorganization is appropriate, it should make a clear report to the stockholders to obtain their formal authorization. The effective date of the readjustment should be as close as practical to the date on which the formal consent of the stockholders is given. Referral should be made to the state laws for the legal requirements for the reorganization.

(4) Full disclosure of the quasi-reorganization should be made in the financial statements by footnote. Retained earnings reported on future balance sheets should be dated to inform the reader of the date from which the reported undistributed profits have been accumulated. The period of such dating should continue as long as deemed necessary; rarely should the period exceed ten years.

(5) After undergoing a quasi-reorganization a corporation has not gained a competitive advantage because there is no effect upon the factors determining competition. The principal effect is to make the readjusted company's financial statements more realistic presentations of financial condition and results of operations without undergoing formal reorganization procedures which would involve recourse to the courts, change in the legal corporate entity and possible interruption in business activity.

Solution 5

a. 1. The unit method of recording depreciation involves the treatment of fixed assets or substantial additions thereto as individual items. The method entails maintaining detailed records of the costs of specific assets and related allowances for depreciation. Computation of depreciation is based on the estimated useful life of the individual asset. The method is distinguished from group and composite-life methods under which the cost and estimated life of the assets are commingled. Depreciation may be recorded by straight-line, accelerated or other accepted computation methods.

2. Under the group or composite-life methods assets are aggregated into accounting units. Such grouping might be horizontal, vertical, or geographical. Horizontal grouping assembles together all assets of similar physical characteristics, such as trucks, presses, returnable containers, etc. A vertical or functional grouping comprises all assets contributing to a common economic function, such as a sugar refinery, service station, etc. The geographical grouping includes all assets in a district or region, such as telegraph poles.

   Depreciation under these methods requires development of a weighted average rate from the assets' depreciable cost and estimated life. Separate accounts are established for the total cost of each asset grouping and its related allowance for depreciation. The asset grouping should be composed of a large number of units to obtain a reliable average life.

b. Arguments for the use of the unit method of computing depreciation are:
1. The method is simple in that it does not require involved mathematical computations.
2. The gain or loss on the retirement of a particular asset can be computed.
3. For cost purposes, depreciation on idle equipment can be isolated.
4. The method results in a more accurately computed depreciation provision in any given year, as the total depreciation charge represents the best estimate of the depreciation of each asset and is not the result of averaging the cost over a longer period of time.

Arguments against the unit method are:
1. Considerable additional bookkeeping is necessary to account for each asset and its related depreciation. (The advent of machine accounting methods reduces the work burden, however.)
2. There is a point of diminishing returns in the accumulation of accounting data under this method; that is, additional accuracy may not justify the additional cost of record keeping.
3. Under a decentralized financial control system where a measure of the division's efficiency is the rate of return on the gross book value of the investment a division manager might scrap fully or nearly fully depreciated equipment to improve his division's rate of return even though the equipment is still serviceable.
4. There may be reluctance on the part of a division manager to replace equipment not fully depreciated with more efficient equipment because of the effect of the loss on the division's profits in the year of replacement.

Arguments for the use of the group and composite-life methods are:
1. The methods require less detailed bookkeeping.
2. The application of depreciation to the whole group tends to average out or offset errors, economic or operating, caused by underdepreciation or overdepreciation.
3. Periodic income is not distorted by gains or losses on disposal of assets.
4. A more useful charge to income is derived from these methods because of their recognition that depreciation estimates are based on averages and that gains and losses on individual assets are of little significance.

Arguments against the use of the group and composite-life methods would include:

1. The methods would conceal faulty estimates for a long period of time.
2. When there is an early heavy retirement of assets a debit balance might appear in the allowance for depreciation account and present an accounting problem.
3. Information is not available regarding a particular machine for cost-calculation purposes.
4. Under a decentralized financial control system where a measure of the division's efficiency is the rate of return of the gross book value of the investment, to improve his division's financial reports a division manager might scrap idle but serviceable equipment or equipment that is not earning a satisfactory return on book value. The company would sustain an actual loss in the amount of the value of the equipment scrapped.
5. Under the same situation as "4" above, except that net book value is used, where the assets, although serviceable, are fully or almost fully depreciated, the division manager might hesitate to replace them because of the high rate of return on investment.

c. Under the unit method retirements are recorded by removing from the accounts the cost of the asset and its related accumulated depreciation. The difference between the two accounts, adjusted for salvage and disposal costs, if any, is recognized as gain or loss.

Under the group and composite-life methods the cost of the retired asset is removed from the asset account, and the accumulated depreciation account is reduced by the amount of the cost of the retired asset, adjusted for salvage, salvage costs, and removal costs. Accordingly there is no periodic recognition of gain or loss; the depreciation allowance account serves as a suspense account for the recognition of gain or loss until the final asset retirement.

Solution 6

a. Intangible assets may be broadly classified into (1) those having a limited term of existence and (2) those having an unlimited term of existence. If their term of existence is limited by law, regulation, agreement, or by their nature, they fall into the first classification. If there is at the time of acquisition no indication of limited life, they are of the second classification.

b. The cost of limited-life intangible assets should be amortized in the income statement over the period benefited, which is not necessarily the maximum or legal life of the assets. Should it be determined subsequently that the original estimate of the period benefited was inaccurate, the amortization rate should be changed to conform with the revised estimate. If the revised amortization rate involves increased charges which cause a material distortion of income, a partial write-down may be made to retained earnings.

An intangible asset that is considered to have unlimited life should remain on the books without being amortized. When it is evident that the term of an unlimited-life intangible asset has become limited, its cost should be amortized in the income statement over the remaining period benefited. If the amortization charge would materially distort the income statement, a partial write-down to retained earnings may be made and the balance of the cost amortized over the remaining period of usefulness.

Even though there is no existing evidence that an unlimited-life intangible asset has suffered a loss in value or has become limited in life, at its discretion management might decide that the intangible may not continue to have value during the entire life of the enterprise. Following such a decision, which is not to be regarded as obligatory, the cost should be amortized in a reasonable manner. Such plan should be formally approved and fully disclosed in the financial statements.

If there is reasonable evidence that an unlimited-life asset has become worthless, its cost should be written off. Such write-off should be made in the income statement. If the amount of the write-off to income would result in misleading inferences, it should be made to retained earnings. The write-off should not be to paid-in capital unless the original credit recording the asset was to that account.

c. The write-off of an intangible asset immediately after acquisition is improper. Such write-off arbitrarily removes an asset from the accounts and violates the fundamental accounting objective of maintaining as accurate a record of costs and the expiration of costs as possible. Moreover, there is disregard of the basic assumption that all expenditures result initially in the acquisition of short- or long-term benefits. Furthermore, removal of the asset distorts the financial statements and any analysis, such as computation of the rate of return, based thereon.

Solution 7

a. Arguments for the specific identification method are as follows:
   (1) It provides an accurate and ideal matching of costs and revenues because the cost is specifically identified with the sales price.
   (2) The method is realistic and objective since it adheres to the actual physical flow of goods rather than an artificial flow of costs.
   (3) Inventory is valued at actual cost instead of an assumed cost.

   Objections to the specific identification method include the following:
   (1) The cost of using it restricts its use to goods of high unit value.
   (2) The method is impractical for manufacturing processes or cases in which units are commingled and identity lost.
   (3) It allows an artificial determination of income by permitting arbitrary selection of the items to be sold from a homogeneous group.
   (4) It may not be a meaningful method of assigning costs in periods of changing price levels.

b. The first-in, first-out method approximates the specific identification method when the physical flow of goods is on a Fifo basis. When the goods are subject to spoilage or deterioration, Fifo is particularly appropriate. In comparison to the specific identification method, an attractive aspect of Fifo is the elimination of the danger of artificial determination of income by the selection of advantageously priced items to be sold. The basic assumption is that costs should be charged in the order in which occurred. As a result the inventories are stated at the latest costs. Where the inventory is consumed and valued in the Fifo manner, there is no accounting recognition of unrealized gain or loss. A criticism of the Fifo method is that it maximizes the effects of price fluctuations upon reported income because current revenue is matched with the oldest costs which are probably least similar to current replacement costs. On the other hand, this method produces a balance sheet value for the asset close to current replacement costs. It is claimed that Fifo is deceptive when used in a period of rising prices because the reported profit is not fully available since a part of it must be used to replace inventory at higher cost.

The results achieved by weighted average method resemble those of the specific identification method where items are chosen at random or there is a rapid inventory turnover. Compared with the specific identification method, the weighted average has the advantage that the goods need not be individually identified; therefore accounting is not so costly and the method can be applied to fungible goods. The weighted average method is also appropriate when there is no marked trend in price changes. In opposition, it is argued that the method is illogical. Since it assumes that all sales are made proportionally from all purchases and that inventories will always include units from the first purchases, it is argued that the method is illogical because it is contrary to the chronological flow of goods. In addition, in periods of price changes there is a lag between current costs and costs assigned to income or to the valuation of inventories.

If it be assumed that actual cost is the appropriate method of valuing inventories, last-in, first-out is not theoretically correct. In general, Lifo is directly adverse to the specific identification method because the goods are not valued in accordance with their usual physical flow. An exception is the application of Lifo to piled coal or ores which are more or less consumed in a Lifo manner. Proponents argue that Lifo provides a better matching of current costs and revenues.

During periods of sharp price movements, Lifo has a stabilizing effect upon reported profit figures because it eliminates paper profits and losses on inventory and smooths the impact of income taxes. Lifo opponents object to the method principally because the inventory valuation reported in the balance sheet could be seriously misleading. The profit figure can be artificially influenced by management through contracting or expanding inventory qualities. Temporary involuntary depletion of Lifo inventories would distort current income by the previously unrecognized price gains or losses applicable to the inventory reduction.

Solution 8

a. 1. Arguments presented for the use of market value or realizable value are:
   (1) This method is proper when the remaining benefits to be realized from the asset are limited to this amount.
   (2) Accordingly, losses in value are recognized in periods of occurrence.

(3) Balance sheet conservatism is achieved by using quoted prices which offer an objective appraisal of the future worth of these assets.
(4) This valuation method realistically reports the amount available for distribution to owners and yet leaves the business in an operating position at the end of the year comparable to the operating position at the beginning of the year.
(5) This method of valuation facilitates management decisions regarding operating policies.
(6) It is the generally accepted method of valuing property received by gift or inheritance.

2. Arguments advanced for using original cost as a valuation basis include:
   (1) The basis is objective, verifiable, consistent and easily understood.
   (2) The basis adheres to the accepted definition of accounting which does not include any built-in interpretative techniques.
   (3) It is an equitable basis for distributing costs to current and future periods.
   (4) To change from an original cost basis would disrupt contractual and business relationships as well as laws and legal precedents which are rooted in existing traditional accounting practices.
   (5) Financial statements can be readily compared from year to year and with other companies' statements.
   (6) Inasmuch as income tax returns are generally on an original cost basis, their preparation is facilitated.
   (7) Any determination of the effects of changes in the value of the dollar uses original cost as a basis.
   (8) This method promptly discloses to stockholders the results of management decisions and provides a measurement of management effectiveness on a fixed dollar basis.

3. Proponents of using appraised values argue as follows:
   (1) Appraised value or replacement cost provides the best expression of the value or utility of an asset to a continuing firm. The replacement asset would have this value—the asset already owned can be no less valuable (with a proper allowance for depreciation).
   (2) Financial statements are more meaningful because consideration is given to variations in the dollar's purchasing power.
   (3) Not only does the use of appraisal values provide a measure of managerial effectiveness in preserving capital in equivalent current dollars, it also affords an evaluation of the company's growth in terms of economic progress.
   (4) The financial statements uniformly report all items of revenue and cost on a "common dollar" or equivalent basis.
   (5) There should be resort to appraised values whenever assets are acquired under the terms of either a bad purchase or a bargain purchase.
   (6) Appraised values are appropriate in determining individual asset values in "basket purchases" or where no market value or cost is available.

(7) Should accounting records be deficient or errors discovered in recorded costs, a resort to appraised values would be expedient.
(8) The availability of current valuations is of benefit to management in the maintenance of capital and other managerial decisions.
(9) Statements on this basis are desirable for the purposes of credit, consolidation or sale of assets.
(10) Discovery of valuable resources and other increases or decreases in value should be recognized for proper accountability and measurement of income through adjustment of depreciation and other charges.
(11) It would be conservative and realistic to recognize a permanent decline in value since such declines are as genuine as fire or casualty losses.
(12) Adjustment of depreciation and other charges to current price levels would have a deterring effect upon swings in the business cycle.

b. The "going concern concept" is the assumption that the life of a business entity is indefinitely long, and hence that the business will continue indefinitely to operate. On that assumption the asset values reported on the balance sheet should be the values to a "going concern" of the benefits which the assets will provide in subsequent periods.

The lower of cost or market value or realizable value is the going concern value generally used for assets, such as receivables, inventories or temporary investments, to be realized promptly in the operating cycle, where reduction to market value is necessary to make the proper charge against the revenues of the period in which the loss in value occurred.

Usually the going concern value for fixed assets is original cost or original cost less estimated depreciation. Such valuation is used because there is no objective evidence that present market values will be more useful than cost as measures of the future benefits of fixed assets to the operation of the business.

Although a number of cogent arguments exist for the use of appraised values to make the financial statements more meaningful, there has been no general acceptance of these values except where no other values are available.

Examples of situations where appraisal values are used would include the reorganization of a business in a new form, the contribution of property to a corporation in connection with its organization, or to allocate costs in a lump-sum price or "basket" purchase.

Answers to Examinations, November 1962

ACCOUNTING PRACTICE—PART I

November 7, 1962; 1:30 to 6:00 p.m.

Solution 1

1.	B	13.	A	25.	False
2.	A	14.	C	26.	False
3.	A	15.	A	27.	False
4.	C	16.	A	28.	True
5.	E	17.	B	29.	True
6.	D	18.	A	30.	False
7.	C	19.	C	31.	False
8.	D	20.	C	32.	True
9.	A	21.	D	33.	False
10.	C	22.	C	34.	True
11.	B	23.	A	35.	True
12.	A	24.	B		

Solution 2

a. Joint cost method:

Computation of Unit Cost of Inventory

Tons	*Production Cost*	*Unit Cost Per Ton*
634	$49,769	$78.50

Note: An acceptable alternative solution would allocate the production costs to each product in proportion to the relative market values of the products produced.

Computation of Unit Market Value of Inventory

Product	*Sales Price*	*Selling Expense**	*Market Value Per Ton*
A	$100.00	$5.00	$95.00
B	100.00	5.00	95.00
C	100.00	5.00	95.00
D	33.00	1.65	31.35

$$\text{*Selling expense} = \frac{\$\ 1{,}224}{\$24{,}480} = 5\%.$$

Computation of Inventory Valuation at December 31, 1961

Product	*Tons*	*Unit Value* *Cost*	*Unit Value* *Market*	*Inventory Valuation*
A	173	$78.50	$95.00	$13,580.50
B	54	78.50	95.00	4,239.00
C	12	78.50	95.00	942.00
D	110	78.50	31.35	3,448.50
	Total inventory at lower of cost or market			$22,210.00

b. By-product method:

Computation of Unit Market Value of Inventory

Product	*Sales Price*	*Selling Expense***	*Market Value Per Ton*
A	$100.00	$5.44	$94.56
B	100.00	5.44	94.56
C	100.00	5.44	94.56
D	33.00	—	33.00

**Computation of selling expense

Sales	$24,480
Less Product D sales (60 tons @ $33)	1,980
Sales of principal products	$22,500

$$\text{Selling expense ratio} = \frac{\$\ 1{,}224}{\$22{,}500} = 5.44\%.$$

Computation of Unit Cost of Inventory

	Tons	*Cost*
Production	634	$49,769
Deduct:		
Sales of Product D @ $33 per ton	(60)	(1,980)
Inventory of Product D @ market of $33 per ton	(110)	(3,630)
Principal products	464	$44,159
Cost per ton		$95.17

Computation of Inventory Valuation at December 31, 1961

Product	*Tons*	*Unit Value* *Cost*	*Unit Value* *Market*	*Inventory Valuation*
A	173	$95.17	$94.56	$16,358.88
B	54	95.17	94.56	5,106.24
C	12	95.17	94.56	1,134.72
D	110	—	33.00	3,630.00
	Total inventory at lower of cost or market			$26,229.84

Solution 3

The Braxton Printing Company

Worksheet for the Six Months Ended June 30, 1962

	December 31, 1961 Balances		*1962 Transactions*				*Revenue and Expense Accounts*		*Balance Sheet Accounts*	
	Debit	*Credit*		*Debit*		*Credit*	*Debit*	*Credit*	*Debit*	*Credit*
Cash	$ 1,650		(1)	$ 27,385	(2)	$ 26,996			$ 2,489	
			(6)	450						
Accounts receivable	1,300		(6)	25,425	(1)	25,025			1,700	
Note receivable			(6)	600					600	
Inventory	2,370		(8)	770					3,140	
Prepaid rent			(10)	100					100	
Prepaid insurance	315		(2)	264	(9)	169			410	
Equipment	8,600		(2)	1,600	(5)	1,000			9,200	
Accumulated depreciation			(5)	125	(4)	1,305				$ 1,180
Cost of sales			(7)	20,431	(8)	770	$19,661			
Salaries			(2)	775			800			
			(3)	25						
Depreciation			(4)	445			445			
Bad debts			(6)	150			150			
Insurance expense			(9)	169			169			
Payroll taxes			(3)	25			25			
Interest expense			(1)	10			10			
Miscellaneous expense			(2)	1,436	(10)	85	1,351			
Loss on sale of equipment			(5)	875	(1)	400	475			
Accounts payable		$ 890	(2)	20,221	(7)	20,431				1,100
Note payable					(1)	2,000				2,000
Discount on note payable			(1)	30					30	
Accrued expenses		55			(10)	15				70
Accrued payroll taxes					(3)	50				50
Robert Braxton, Capital		13,290	(4)	860						12,430
Robert Braxton, Drawing			(2)	2,700					2,700	
Sales					(6)	26,625		$26,625		
Net income for period							3,539			3,539
	$14,235	$14,235		$104,871		$104,871	$26,625	$26,625	$20,369	$20,369

Entries to Give Effect to 1962 Transactions

(Not required)

(1)

Cash		$27,385	
Discount on note payable		30	
Interest expense		10	
Accounts receivable			$25,025
Loss on sale of equipment			400
Note payable			2,000
To record cash receipts.			

(2)

Accounts payable		20,221	
Prepaid insurance		264	
Salaries		775	
Robert Braxton, Drawing		2,700	
Equipment		1,600	
Miscellaneous expense		1,436	
Cash			26,996
To record cash disbursements			

(3)

Salaries		25	
Payroll taxes		25	
Accrued payroll taxes			50
To record payroll taxes.			
Salary, 3 months	$800		
Social security tax	3⅛ %		
Employee contribution	25		
Employer contribution	25		
Total	$ 50		

(4)

Depreciation			445	
Robert Braxton, Capital			860	
Accumulated depreciation				1,305
To record depreciation for 1961 and 1962.				
1961 depreciation:				
$\$8,600 \times 10\% =$		$ 860		
1962 depreciation:				
$\$7,600 \times 10\% \times 6/12 =$	$380			
$\$1,000 \times 10\% \times 3/12 =$	25			
$\$1,600 \times 10\% \times 3/12 =$	40	445		
		$1,305		

(5)

Loss on sale of equipment		875	
Accumulated depreciation		125	
Equipment			1,000
To remove from books equipment that was sold.			
Cost of equipment	$1,000		
Accumulated depreciation, 1-3/12 years at 10%	$125		

(6)

Cash			450	
Accounts receivable			25,425	
Note receivable			600	
Bad debts			150	
Sales				26,625
To record sales for the period.				
Ending accounts receivable	$ 1,700			
Note receivable	600			
Bad debt write-off	150			
Cash in transit	450			
Cash collections	25,025			
Total	27,925			
Beginning accounts receivable	1,300			
Sales for the period	$26,625			

(7)

Cost of sales		20,431	
Accounts payable			20,431
To record purchases for the period.			
Ending accounts payable	$ 1,100		
Payments to creditors	20,221		
Total	21,321		
Beginning accounts payable	890		
Purchases for the period	$20,431		

(8)

Inventory		770	
Cost of sales			770
To record increase in inventory.			
Ending inventory	$3,140		
Beginning inventory	2,370		
Increase in inventory	$ 770		

(9)

Insurance expense	169	
Prepaid insurance		169
To record insurance expense for the period.		

Policy	*Unexpired or Premium*	*Period Covered*	*Expired*	*Expense*
# 2479	$240	24 mos.	6 mos.	$ 60
C2160	75	5 mos.	5 mos.	75
831	72	12 mos.	3 mos.	18
C2380	192	12 mos.	1 mo.	16
				$169

(10)

Prepaid rent	100	
Accrued expenses		15
Miscellaneous expense		85
To record prepaid rent and increase in accrued expenses.		

Accrued expenses, June 30	$70
Accrued expenses, December 31	55
Increase	$15

Solution 4

a. Computation of Ordinary Income and Other Items

Ordinary income:			
Sales			$220,000
Cost of goods sold		$120,975	
Operating expenses		42,000	
Partner's salary		6,000	
Mortgage interest		1,250	
Bad debts		200	
Depreciation on buildings:			
40,000 × 2-1/2%		1,000	
Depreciation on furniture and fixtures:			
$11,250 × 6-2/3%	$750		
$ 3,750 × 6-2/3% × 1/2	125		
$15,000 × 6-2/3% × 1/2	500	1,375	172,800
Ordinary income			$ 47,200
Net long-term capital gain:			
Stock sold—amount received		$11,080	
Tax basis		6,400	
Net long-term capital gain			$4,680
Net loss under Section 1231:			
Amount received			$2,075
Cost		$3,750	
Depreciation, 1958-60	$750		
Depreciation, 1961 (½ year)	125	875	2,875
Net loss			$ 800

b. **Distribution of Ordinary Income**

	Total	*A*	*B*
Interest @ 6% on closing capital balances	$ 7,980	$ 2,280	$ 5,700
Distribution of remaining ordinary income	39,220	19,610	19,610
Total	$47,200	$21,890	$25,310

Computation of Interest on Closing Capital Balances

	A	*B*
Capital account	$50,000	$100,000
Less drawing account	12,000	5,000
Closing capital balance	$38,000	$ 95,000
Interest @ 6%	$ 2,280	$ 5,700

c. **Tax Basis of Partners' Interests**

	Total	*A*	*B*
Capital contributed:			
Cash	$ 50,000	$50,000	
Municipal bonds	10,050		$ 10,050
Stock of U. S. Corporations	6,400		6,400
Land	8,000		8,000
Building	24,000		24,000
Furniture & fixtures	12,000		12,000
Inventory	40,000		40,000
Total	150,450	50,000	100,450
Adjustment for mortgage assumed		12,500	(12,500)
Total	150,450	62,500	87,950
Ordinary income	47,200	21,890	25,310
Net long-term capital gain	4,680	2,340	2,340
Qualifying dividends	700	350	350
Interest on municipal bonds	380	190	190
Total	203,410	87,270	116,140
Less:			
Section 1231 loss	800	400	400
Amortization of premium on bonds	50	25	25
Charitable contributions	500	250	250
Unallowable contributions	1,500	750	750
Drawings	17,000	12,000	5,000
Total deductions	19,850	13,425	6,425
Tax basis of partners' interests	$183,560	$73,845	$109,715

Solution 5

Estate of Arthur Taine, Deceased
David Taine, Executor

CHARGE AND DISCHARGE STATEMENT
May 31, 1961 through July 1, 1962

		See Schedule
Principal		
I charge myself with:		
Original capital of estate	$398,050	A
Gain on disposal of estate assets	400	B
Total	398,450	
I credit myself with:		
Loss on disposal of estate assets	1,190	C
Funeral, administration and other expenses	85,000	D
Debts of decedent paid	10,910	E
Legacies paid or delivered	19,900	F
Total	117,000	
Balance, July 1, 1962 (See Schedule I for proposed plan of distribution.)	$281,450	H
Income		
I charge myself with:		
Income collected	$ 5,850	J
I credit myself with:		
Expense applicable thereto and distributions to Bertha Taine, widow	5,375	K
Balance, July 1, 1962, consisting of cash in checking account	$ 475	G

Estate of Arthur Taine, Deceased
David Taine, Executor

ORIGINAL CAPITAL OF ESTATE
May 31, 1961

Schedule A

Cash in checking account, Fidelity National Bank	$143,000
$100,000 United States Treasury bonds, 3%, 1999	100,000
Accrued interest on same, March 1, 1961 through May 31, 1961	750
$9,700 Seneca Co. first mortgage notes, 6%, 1965	9,900
800 shares Puritan Co. common stock, ex-dividend	64,000
Dividend on same declared May 7, 1961 payable to holders of record May 27, 1961	800
700 shares Meta Mfg. Co. common stock	70,000
Personal effects—diamond ring	9,600
Total	$398,050

Estate of Arthur Taine, Deceased
David Taine, Executor

GAIN ON DISPOSAL OF ESTATE ASSETS
May 31, 1961 through July 1, 1962

Schedule B

Specific cash legacy to be paid to David Taine, per will	$10,000
Less value, per Schedule A, of diamond ring elected to be taken in lieu of cash	9,600
Gain on disposal of estate assets	$ 400

Estate of Arthur Taine, Deceased
David Taine, Executor

LOSS ON DISPOSAL OF ESTATE ASSETS
May 31, 1961 through July 1, 1962

Schedule C

Sale of 700 shares Meta Mfg. Co. common stock:	
Inventory value, per schedule A	$70,000
June 19, 1961 sale	68,810
Loss on disposal of estate assets	$ 1,190

Estate of Arthur Taine, Deceased
David Taine, Executor

FUNERAL, ADMINISTRATION AND OTHER EXPENSES
May 31, 1961 through July 1, 1962

Schedule D

Funeral expenses	$ 2,000
Federal and state estate taxes	58,000
Attorney's and accountant's fees	25,000
Total	$85,000

Estate of Arthur Taine, Deceased
David Taine, Executor

DEBTS OF DECEDENT PAID
May 31, 1961 through July 1, 1962

Schedule E

Assessments for additional 1959 federal and state income taxes ($1,700) plus interest ($110)	$ 1,810
Balance of testator's 1961 income taxes	9,100
Total	$10,910

Estate of Arthur Taine, Deceased
David Taine, Executor

LEGACIES PAID OR DELIVERED
May 31, 1961 through July 1, 1962

Schedule F

David Taine—diamond ring inventoried at $9,600 in lieu of cash, legacy (see also Schedule B)	$10,000
Elaine Taine Langer—specific legacy of Seneca Co. first mortgage notes, 6%, 1965	9,900
Total	$19,900

Estate of Arthur Taine, Deceased
David Taine, Executor

EXECUTOR'S CASH ACCOUNT
May 31, 1961 through July 1, 1962

Schedule G
(Not required)

Receipts	*Total*	*Principal*	*Income*
Transfer from Fidelity National Bank	$143,000	$143,000	
Interest collected on bonds:			
United States Treasury, Sept. 1, 1961	1,500	750	$ 750
March 1, 1962	1,500		1,500
Dividends received on stock:			
Puritan Co., June 15, 1961	800	800	
Sept. 15, 1961	800		800
Dec. 15, 1961	1,200		1,200
March 15, 1962	800		800
June 15, 1962	800		800
Proceeds of June 19, 1961 sale of 700 shares Meta Mfg. Co.	68,810	68,810	
Total receipts	219,210	213,360	5,850
Disbursements			
Funeral expense	2,000	2,000	
Federal and state personal income taxes:			
1959 assessments, including interest	1,810	1,810	
1961 balance, January 1, 1961 - May 31, 1961	9,100	9,100	
Federal and state fiduciary income taxes:			
1961 (June 1, 1961 - June 30, 1961)	75		75
1962 (July 1, 1961 - June 30, 1962)	1,400		1,400
Federal and state estate taxes	58,000	58,000	
Monthly payments to Bertha Taine, widow:			
13 payments of $300	3,900		3,900
Attorney's and accountant's fees	25,000	25,000	
Total disbursements	101,285	95,910	5,375
Balance, cash in checking account, July 1, 1962	$117,925	$117,450	$ 475

Estate of Arthur Taine, Deceased
David Taine, Executor

ASSETS ON HAND
July 1, 1962

Schedule H

$100,000 United States Treasury bonds, 3%, 1999	$100,000
800 shares Puritan Co. common stock	64,000
Principal cash	117,450
Total	$281,450

Estate of Arthur Taine, Deceased
David Taine, Executor

PROPOSED PLAN OF DISTRIBUTION OF ESTATE ASSETS
July 1, 1962

Schedule I

To David Taine, Trustee for Bertha Taine:		
$100,000 United States Treasury bonds, 3%, 1999		$100,000
800 shares Puritan Co. common stock		64,000
Total		164,000
To the two residual legatees:		
David Taine	$58,725	
Elaine Taine Langer	58,725	
Principal cash		117,450
Total, per Schedule H		$281,450

Note: An alternative solution would assume that the estate had been terminated and would include the Income Cash of $475 in the proposed plan of distribution of estate assets.

Estate of Arthur Taine, Deceased
David Taine, Executor

INCOME COLLECTED
May 31, 1961 through July 1, 1962

Schedule J

Interest on bonds:		
United States Treasury, Sept. 1, 1961	$1,500	
March 1, 1962	1,500	
Total	3,000	
Less accrued at May 31, 1961	750	$2,250
Dividends on stock:		
Puritan Co., Sept. 15, 1961	800	
Dec. 15, 1961	1,200	
March 15, 1962	800	
June 15, 1962	800	3,600
Total		$5,850

Estate of Arthur Taine, Deceased
David Taine, Executor
DISTRIBUTIONS OF INCOME
May 31, 1961 through July 1, 1962
Schedule K

Federal and state fiduciary income taxes:	
Fiscal year ended June 30, 1961	$ 75*
Fiscal year ended June 30, 1962	1,400*
Monthly payments of income to Bertha Taine, widow, from June 1, 1961 through July 1, 1962—13 payments of $300	3,900
Total	$5,375

*An alternative solution would charge these amounts to principal.

Estate of Arthur Taine, Deceased
David Taine, Executor
OTHER INFORMATION
May 31, 1961 through July 1, 1962
Schedule L (Not required)

The following assets of the estate did not pass into the hands of the executor:	
Personal residence—devised to Bertha Taine, widow	$ 45,000
York Life Insurance Co.—term life insurance policy on life of Arthur Taine. Beneficiary—Bertha Taine, widow	120,000
Granite Trust Co.—savings bank account, Arthur Taine, in trust for Philip Langer (grandchild)	400
Total	$165,400
The following assets of the estate were collected without gain or loss:	
Fidelity National Bank—checking account	$143,000
Interest accrued at date of death:	
$100,000 United States Treasury bonds	750
Dividends accrued at date of death:	
Puritan Co.	800
Total	$144,550

Pursuant to the deceased's testamentary instructions, estate taxes have not been apportioned.

Estate of Arthur Taine, Deceased
David Taine, Executor
CALCULATION OF ACCRUALS WHICH CONSTITUTE ESTATE ASSETS
May 31, 1961
(Not required)

Interest accrued on $100,000 United States Treasury bonds, 3%, 1999, interest payable March and September 1

$$100{,}000 \times 3\% \times \frac{3}{12} = \qquad \$750$$

Dividends declared and payable to holders of record prior to date of death:

800 shares Puritan Co. @ $1 per share $800

ACCOUNTING PRACTICE—PART II

November 8, 1962; 1:30 to 6:00 p.m.

Solution 1

a.

Sleepy Haven Township
GENERAL FUND
Analysis of Changes in Unappropriated Surplus
for Fiscal Year Ending June 30, 1962

	Estimated	*Actual*	*Excess* or Deficiency of Actual Compared with Estimated*
Unappropriated surplus, July 1, 1961	$10,000	$10,000	—
Add:			
Reserve for encumbrances of prior year	4,400	4,400	—
Revenues	70,000	76,000	6,000*
Surplus receipts	—	700	700*
Total additions	74,400	81,100	6,700*
Total balance and additions	84,400	91,100	6,700*
Deduct:			
Appropriation expenditures	72,000	71,250	750
Expenditures chargeable against reserve for encumbrances of prior year	4,400	4,250	150
Reserve for encumbrances, June 30, 1962	—	3,700	3,700*
Total deductions	76,400	79,200	2,800*
Unappropriated surplus, June 30, 1962	$ 8,000	$11,900	$3,900*

Sleepy Haven Township
GENERAL FUND—UNAPPROPRIATED SURPLUS ACCOUNT
(Not required)

Appropriations	$72,000	Balance, 7/1/61	$10,000
Balance, 6/30/62, before adjusting and closing entries	8,000	Estimated revenue	70,000
	$80,000		$80,000
Reserve for encumbrances, 6/30/62	$ 3,700	Balance, 6/30/62, before adjusting and closing entries	$ 8,000
		Excess of actual revenue over estimated	6,000
		Surplus receipts	700
		Excess of appropriation expenditures over appropriations	750
Final balance, 6/30/62	11,900	Excess of reserve for encumbrances of prior year over expenditures	150
	$15,600		$15,600
		Final balance, 6/30/62	$11,900

b.

Sleepy Haven Township
GENERAL FUND
Balance Sheet—June 30, 1962

ASSETS

Cash		$ 1,100
Taxes receivable—current	$8,200	
Less—Allowance for uncollectible current taxes	150	8,050
Taxes receivable—delinquent	2,500	
Less—Allowance for uncollectible delinquent taxes	1,650	850
Miscellaneous accounts receivable	4,000	
Less—Allowance for uncollectible accounts	400	3,600
Due from Working Capital Fund		5,000
		$18,600

LIABILITIES, RESERVES AND SURPLUS

Liabilities:		
Vouchers payable	$2,000	
Due to Utility Fund	1,000	$ 3,000
Reserve for encumbrances		3,700
Unappropriated surplus		11,900
		$18,600

Solution 2

a. COMPUTATION OF CORRECTED NET INCOME FOR 1961

Adjusted net income as reported		$268,000
Fire loss adjustment:		
Loss sustained	$ 15,000	
Charge to Insurance Expense	7,000	(8,000)
Inventory writedown adjustment:		
Reserve to Reduce Inventory Cost to Market,		
Balance, December 31, 1961	23,000	
Balance, January 1, 1961	9,000	
Inventory loss in 1961	14,000	
Portion charged to Reserve for Future Inventory Loss	60%	
Loss charged to Reserve for Future Inventory Loss	8,400	
Provision charged to Cost of Goods Sold	3,000	
Additional inventory writedown to be charged to 1961 operations		(5,400)
Contingencies adjustment:		
Adjusted net income as reported	268,000	
Basic income	250,000	
60% of unadjusted income in excess of $250,000	18,000	
100% of unadjusted income in excess of $250,000 ($18,000 ÷ 60%)	30,000	
Income credited to Reserve for Contingencies		12,000
Corrected net income for 1961		$266,600

Note: No depreciation adjustment is required because depreciation based upon production is acceptable.

b. COMPUTATION OF RETAINED EARNINGS AT DECEMBER 31, 1961

Balance, December 31, 1960	$ 88,684	
Corrected net income for 1961	266,600	$355,284
Cash dividend paid on preferred stock ($6.00 × 950 shares)	5,700	
April 1, cash dividend paid on common stock ($.25 × 55,000 shares)	13,750	
June 30, 4% stock dividend (55,000 × 4% × $25)	55,000	
December 31, 4% stock dividend (57,200 × 4% × $30)	68,640	143,090
Balance, December 31, 1961		$212,194

c. COMPUTATION OF BOOK VALUE PER SHARE OF COMMON STOCK

Preferred stock		$ 100,000
Premium on preferred stock		20,000
Common stock		594,880
Premium on common stock		64,000
Paid-in capital from common stock dividend*		78,760
Retained earnings		212,194
Reserve for contingencies		45,000
Reserve for fire insurance		21,000
Reserve for future inventory loss		40,000
		1,175,834
Less:		
Preferred stock in treasury	$ 5,300	
Liquidation value of preferred stock (950 × $105)	99,750	105,050
Book value of common stock equity		$1,070,784
Book value per share of common stock ($1,070,784 ÷ 59,488)		$18.00

**Paid-in Capital from Common Stock Dividend*

June 30, 4% stock dividend—55,000 × 4% × $25 =		$55,000	
Credit to common stock	$12,000		
Credit to treasury stock	10,000	22,000	
Credit to paid-in capital			$33,000
Dec. 30, 4% stock dividend—57,200 × 4% × $30 =		68,640	
Credit to common stock		22,880	
Credit to paid-in capital			45,760
Total paid-in capital from common stock dividend			$78,760

Solution 3

a.

The Rocky Gravel Company
NET INCOME PROJECTION
For the Year Ending December 31, 1962

Sales	$352,000
Production costs:	
Direct labor	111,000
Depreciation	11,500
Depletion	3,300
Other	63,400
Total production costs	189,200
Gross profit	162,800
Administrative expenses	69,400
Profit before income taxes	93,400
Provision for federal income taxes	39,600
Net profit after income taxes	$ 53,800

COMPUTATION OF SALES

1961 cubic yards sold ($300,000 ÷ $1.50)	200,000
1962 cubic yards (200,000 × 110%)	220,000
Average sales price per cubic yard	$1.60
1962 sales	$352,000

COMPUTATION OF DIRECT LABOR

1961 direct labor	$110,000
Less inefficient direct labor	10,000
1961 efficient direct labor	100,000
10% increase in production	10,000
5% increase in hourly rate	5,500
Total	$115,500
1962 direct labor, January-June (6/12 of $115,500)	$ 57,800
1962 direct labor, July-December (92% of $57,800)	53,200
Total 1962 direct labor	$111,000

COMPUTATION OF DEPRECIATION

1962:	
Original equipment ($150,000 × 6-2/3%)	$10,000
New equipment ($60,000 × 5% × 6/12)	1,500
Total 1962 depreciation	$11,500

COMPUTATION OF COST DEPLETION

1961 depletion	$3,000
1962 depletion (110% × $3,000)	$3,300

COMPUTATION OF OTHER PRODUCTION COSTS

1961 total production costs		$184,000
Less:		
1961 depletion	$ 3,000	
1961 depreciation	10,000	
1961 direct labor	110,000	123,000
1961 other production costs		$ 61,000
1962 other production costs (104% × $61,000)		$63,400

COMPUTATION OF ADMINISTRATIVE EXPENSES

Total 1961 administrative expense	$60,000
Interest on chattel mortgage	1,400
Anticipated increase	8,000
Total 1962 administrative expense	$69,400

COMPUTATION OF INTEREST ON CHATTEL MORTGAGE

Cost of new equipment	$60,000
Less 20% down payment	12,000
Amount of chattel mortgage	$48,000
1962 interest ($48,000 × 6% × 6/12)	$ 1,400

COMPUTATION OF PROVISION FOR FEDERAL INCOME TAXES

Net income before provision for federal income taxes	$ 93,400
Add cost depletion	3,300
Total	96,700
Less percentage depletion (5% × $352,000)	17,600
Taxable income	$ 79,100
Provision for federal income taxes @ 50%	$ 39,600

COMPUTATION OF INCREASE IN ACCOUNTS RECEIVABLE

Ratio of accounts receivable to sales for 1961 $\frac{\$24,000}{\$300,000} = 8\%$

Projected sales for 1962	$352,000
Projected accounts receivable for 1962 ($352,000 × 8%)	$ 28,200
Accounts receivable, December 31, 1961	24,000
Increase in accounts receivable	$ 4,200

b.

The Rocky Gravel Company
CASH FLOW PROJECTION
For the Year Ending December 31, 1962

Cash on hand, December 31, 1961		$ 17,000
Sources of cash:		
Net income	$53,800	
Add noncash expenses:		
Depreciation	11,500	
Depletion	3,300	
Amortization of organization expense	1,000	
Provision for federal income taxes	39,600	
Cash provided by operations		109,200
Chattel mortgage for equipment		48,000
Total cash provided		174,200
Application of cash:		
Payment of 1961 income taxes	22,000	
Purchase of equipment	60,000	
Reduction of chattel mortgage	8,000	
Increase in accounts receivable	4,200	
Total application of cash		94,200
Balance		80,000
Minimum cash balance		20,000
Available to reduce notes payable to officers		$ 60,000

Solution 4

a. Capital stock	$15,000	
Paid-in capital from treasury stock transactions		$ 5,000
Treasury stock		10,000
To cancel the treasury stock.		

b. **COMPUTATION OF STOCKHOLDERS' EQUITY**

Capital stock	$ 60,000
Premium on stock	37,500
Paid-in capital from treasury stock transactions	5,000
Retained earnings	17,500
Total stockholders' equity	$120,000
Number of shares outstanding	600
Net book equity per share	$200
Individual Stockholder's Equity	
F. A. Bank (100 × $200)	$ 20,000
J. R. Fenn (350 × $200)	70,000
M. A. Rola (150 × $200)	30,000
Total stockholders' equity	$120,000

c. COMPUTATION OF NUMBER OF NEW SHARES TO BE ISSUED

Let X = Number of shares of new common stock.
The total equity of the common stockholders consists of premium on stock ($37,500), paid-in capital from treasury stock transactions ($5,000), retained earnings ($17,500) and X shares at $100 par value. M. A. Rola, whose equity is $30,000, will receive 40% of the common stock and no preferred stock, therefore:

$$.40\ (\$37{,}500 + \$5{,}000 + \$17{,}500 + \$100X) = \$30{,}000$$
$$X = 150 \text{ shares}$$

Total new shares (common and preferred)	600
Total new common shares	150
Total new preferred shares	450

d. COMPUTATION OF DISTRIBUTION OF NEW SHARES OF STOCK

	Preferred Stock		Common Stock		Retained Earnings and Paid-in Capital from Recapitalization	Total Net Worth
	#	Amount	#	Amount		
Total shares and net worth after recapitalization	450	$45,000	150	$15,000	$60,000	$120,000
Allocated to F. A. Bank (preferred only). 200 shares at $100 par value to retain his equity of $20,000	(200)	(20,000)				(20,000)
Allocated to M. A. Rola (common only). 40% of 150 shares			(60)	(6,000)	(24,000)	(30,000)
Allocated to J. R. Fenn	250	$25,000	90	$9,000	$36,000	$70,000

Solution 5

a.

The Glo-Bright Company
1961 Income Statement

	Unconverted	*Converter*	*Converted*
Revenues	$42,350	100/121	$35,000
Less: Cost of sales	18,403	*	15,230
Depreciation—building	2,000	100/80	2,500
Depreciation—equipment	3,600	100/90	4,000
Other expenses	9,075	100/121	7,500
Total	33,078	—	29,230
Net income	$ 9,272		$ 5,770

*Cost of sales:

Beginning inventory	$ 4,000	100/80	$ 5,000
	500	100/100	500
	1,100	100/110	1,000
	5,600		6,500
Purchases	18,150	100/121	15,000
Total available	23,750		21,500
Less: Ending inventory	4,000	100/80	5,000
	500	100/100	500
	847	100/110	770
	5,347		6,270
Total cost of sales	$18,403		$15,230

$5,770 ÷ 2,000 shares = $2.885 per share earnings in terms of 1959 dollars.

b. Dividends received by Arnett in 1961: $4,000 × 100/121 = $3,305.79 in terms of 1959 dollars.

	1959	*1961*
Dividends received by Arnett in terms of 1959 dollars	$4,000	$3,305.79
Rate of return on $50,000 investment	8%	6.6%

Solution 6

a. **COMPUTATION OF NET INCOME BEFORE INCOME TAXES AND BONUSES**

Sales		$337,000
Cost of goods sold		215,000
Gross margin		122,000
Less: Selling expenses	$27,000	
General expenses	19,000	46,000
Income before adjustments		76,000
Add: Overdepreciation of fixtures	1,700	
Interest income	400	
Tax adjustment	11,300	13,400
Net income before income taxes and bonuses		$ 89,400

b. COMPUTATION OF TAXABLE INCOME BEFORE BONUSES

Net income before income taxes and bonuses		$89,400
Add: Additional excess depreciation of fixtures		1,000
		90,400
Deduct: Patent write-off	$25,000	
Additional depreciation on machinery for tax purposes	12,000	
Nontaxable bond interest	400	37,400
Taxable income before bonuses		$53,000

c. COMPUTATION OF LIMITATION OF BONUSES

Average paid-in capital:	
2 months at $70,000	$140,000
10 months at $85,000	850,000
Total	$990,000
Average paid-in capital (÷ 12)	$ 82,500
Bonus limitation (25%)	$ 20,625

d. COMPUTATION OF BONUSES AND INCOME TAX

Let A = Able's bonus
B = Baker's bonus
T = Income tax

1. A = .20 ($100,000 — A — B — T)
2. B = .50 A
3. T = .50 ($70,000 — A — B)
4. (Substitute 2 in 1) A = .20 ($100,000 — A — .50 A — T)
5. (Substitute 2 in 3) T = .50 ($70,000 — A — .50 A)
6. (Substitute 5 in 4) A = .20 [$100,000 — A — .50 A — .50 ($70,000 — A — .50 A)]
7. A = $11,304.35
8. (Substitute 7 in 2) B = .50 ($11,304.35)
9. B = $5,652.17
10. (Substitute 7 & 9 in 3) T = .50 ($70,000 — $11,304.35 — $5,652.17)
11. T = $26,521.74

PROOF OF COMPUTATION

Adjusted book net income		$100,000.00
Less: Tax	$26,521.74	
A's bonus	11,304.35	
B's bonus	5,652.17	43,478.26
Base subject to bonus		$56,521.74
A's bonus @ 20%		$11,304.35

AUDITING

November 8, 1962; 8:30 a.m. to 12:00 m.

Solution 1

a. 1. The cashier could destroy cash or C.O.D. sales tickets and pocket the proceeds if sales tickets are not prenumbered or if accountability is not maintained for all sales ticket numbers.

2. Lapping might occur. This involves the withholding of cash receipts without an entry being made on the books. At a later date cash is collected and an entry is made for the first cash collected. The latest collection is held and used by the dishonest person. In the situation described any of the four Alaska employees could lap the collections of accounts receivable.

3. Since the assistant credit manager had been told of doubtful accounts previously written off as uncollectible, he could appropriate cash collections to the extent of the remittances received on accounts previously written off.

4. The credit department personnel could enter discounts not taken by the customer or enter discounts on remittances made after the discount date; these entries could cover the appropriation of an equivalent amount of cash for his personal use.

5. Since no record is made of mail receipts until they have been handled by four people, any of the four could abstract funds without any covering action. Upon discovery of the theft there would be no records to identify the thief.

6. The assistant credit manager could cover abstractions of cash by adding or destroying accounts receivable ledger cards, by falsifying subsidiary ledger trial balances, by sending statements which differ from the accounts, etc.

b. The following procedures should be put into effect at the Alaska Office to strengthen the internal control over cash receipts:

1. All sales tickets should be prenumbered and all sales ticket numbers should be accounted for daily. All sales tickets stamped "paid" should be reconciled to the duplicate deposit slip receipted by the bank. This should be done by a responsible employee other than the cashier or a member of the credit department.

2. An employee other than the cashier or a member of the credit department should open the incoming mail and prepare daily a list in triplicate of remittances received that day. The original of the list should accompany the checks (and cash, if any) turned over directly to the cashier; one copy of the list of remittances should be routed to the responsible employee mentioned "1" above; and one copy should be routed to the person responsible for posting to the accounts receivable ledger.

3. The responsible employee who received the copy of the list of remittances should compare the remittances shown thereon with the duplicate deposit ticket at

the same time he reconciles the cash sales tickets to the deposit ticket. Any checks or cash not deposited the day received should be investigated.

4. Different forms (or colors) of sales tickets for cash, C.O.D., and credit sales would facilitate the daily accounting for sales tickets used.

5. The cashier, who should have no duties connected with accounts receivable, should prepare bank deposits, and forward the deposit to the bank. A responsible employee other than the cashier or a member of the credit department should establish agreement of the list of remittances and daily collections with the daily deposit ticket.

6. Remittances should not be held; those for each day or for each batch of mail, whichever is the more practical, should be deposited intact. The credit department may make whatever record it needs for further follow-up on the remittances that are not in the correct amount.

7. The duty of posting remittances to the accounts receivable ledger cards may be left with the credit department. This operation should normally be performed subsequent to the receipt and control of cash; therefore internal control over cash will not be weakened if credit department personnel perform the posting duty, providing they have no access to the cash represented by the remittance advices.

Solution 2

a. The CPA assumes no responsibility for the discovery of conflicts of interest during the course of his regular audit. There are almost innumerable ways in which a conflict of interest may exist. To investigate these possibilities is beyond the scope of the regular examination of the company's financial statements, and their investigation would result in a costly extension of detail work. Moreover, it is unlikely that evidence of a conflict of interest would appear in the client's records or supporting documents which the CPA audits during his examination, and he should assume no responsibility for the discovery of a situation not recorded and about which he has no means of learning.

Should evidence of a conflict of interest come to the CPA's attention in the audit of the client's statements (for example, during his test of inventory pricing he might discover the purchase of materials at prices in excess of market) he has the responsibility of reporting the matter to the proper authority. Furthermore, it is an appropriate service to direct the client's attention to the possibility of conflicts of interest among the employees.

b. A statement regarding conflicts of interest is not usually included in a letter of representation. Including it, however, would cause the person signing the letter to consider whether reasonable steps had been taken or sufficient inquiry made to justify his making any statement on the matter.

Should the signing official refuse to include the statement in the letter, the matter should be brought to the attention of the board of directors. Since it would be extremely unusual for a conflict of interest to cause the financial statements to be misleading and because there is no basis for maintaining that a conflict of interest exists, such a refusal would not cause the CPA to express any qualification or exception in his report.

c. 1. The CPA has a professional responsibility to keep the affairs of his client confidential. He therefore could reveal the practice to the president of the Mark Company only if (a) the Timzin Company granted permission for him to reveal it or (b) he is able to establish the existence of the practice by means which are not related to the Timzin engagement.

2. If the "kickbacks" are minor in nature and the CPA knows that officials of the Timzin Company are aware of the practice, then the CPA should remain silent on the matter in recognition of his confidential relationship with his client.

On the other hand, if the CPA considers the "kickbacks" to be a serious wrongdoing on the part of the Timzin Company which would require disclosure in the financial statements or his report, then the CPA can only withdraw from the audit of the Timzin Company. Even after his withdrawal, however, his confidential relationship with Timzin is not broken and the information that he has learned cannot be divulged.

Solution 3

a. 1. Since the purchase of the stock was not made through a broker there would probably be no invoice in support of the transaction. The cancelled check and any documents existing as evidence of the transaction should be examined.

2. The minutes of the meetings of the board of directors should be examined for authority for the purchase.

3. The stock certificate should be inspected at the balance sheet date and, if cash balances are verified at a date other than the balance sheet date, also on the date of such verification.

4. The Home Building Corporation should be requested to confirm that its records show the changeover in ownership and that Sandy Core Company is the owner of the 100 shares on the balance sheet date. In connection with the verification of dividend income, information regarding 1961 dividends should be requested in the same letter.

5. The investment is material in relation to the client's net worth. Furthermore, because the stock was purchased from the client's president a question arises regarding the arm's length aspect of the transaction. It is important, therefore, to determine the reasonableness of the cost of the investment at the date of purchase and its approximate value at December 31, 1961 for reporting purposes. Financial statements, audited if possible, of the Home Building Corporation should be procured and studied for these determinations.

6. The nature and purpose of the investment should be discussed with the president of Sandy Core Company.

7. A list of the stockholders of the Home Building Corporation should be obtained to shed additional light on the relationship between the two companies.

8. The transactions recorded on the Sandy Core books between the two companies should be carefully examined to determine whether they were made at arm's length.

9. If the Home Building Corporation does not have its financial statements audited, the independent public accountant should take additional steps to deter-

mine that the business appears to be legitimate and not merely a fictitious entity formed to defraud stockholders. His investigation would include inspecting the premises; discreet inquiring of authorities, such as bankers, who might have knowledge of its affairs; and obtaining reports from financial credit rating services. The transactions on the books of Sandy Core would be another indication of the legitimacy of the business.

b. Because the investment is material in relation to the client's net worth and a quoted market value is not available, the book value of the investment at the balance sheet date should be determined from the Home Building Corporation's financial statements, audited if possible. The book value would be the client's proportion of the total stockholders' equity of the issuing company.

If the client's equity is substantially less than the cost of the stock, the matter should be discussed with the client. Perhaps factors other than book value contributed to the determination of the price of the stock. Such factors might include the trend of earnings, dividends paid, retention of a large customer, etc.

However, if there is reason to believe that the difference between the cost and the estimated market value is actual and permanent in nature, the investment should be written down to its realistic value. If the writedown is unnecessary, the investment should be stated at cost and the book value of the client's equity stated in the client's financial statements—either parenthetically on the balance sheet or in a footnote thereto.

The relative size of the investment and the correlative business activities of the two firms indicate that the investment is not a temporary one. If such is the case, the investment should be reported as a noncurrent asset. Another reason for showing it as a noncurrent asset is that the stock has no ready market.

Because the amount of the investment is material, full disclosure of the details of the investment should be made in a footnote. Such full disclosure would include stating the nature and purpose of the investment in the Home Building Corporation.

Solution 4

a. The objective of the CPA's examination and accumulation of accounting evidence is to obtain sufficient competent evidential matter to afford a reasonable basis for an opinion regarding the financial statements under examination.

b. The source of evidence is of primary importance in determining its reliability. The client's books and records are compared with the financial statements to establish their agreement, but the CPA knows that the validity of the books and records depends on the quality of the internal control and the reliability of the evidence supporting transactions and statement amounts. He rates the classes of the supporting evidence in the following approximate order of their reliability:

1. Heavy reliance is placed on physical evidence which supports the existence of tangible assets such as inventory and fixed assets. To the extent that cash and securities can be inspected and counted, they too are physical evidence.

2. Heavy reliance is also placed on documents prepared by third parties and forwarded directly to the auditor. Examples are confirmations of account balances or security accounts and bank certifications.

3. Documents prepared by third parties and held by the client can be questioned for genuineness, especially if the documents can be altered easily. Such evidence includes notes receivable or inventory reports from public warehouses.

4. Evidence originated by the business and passing through the hands of third parties would merit considerable reliance. Examples are items such as cancelled checks, receipted bills of lading and receipted bank deposit slips.

5. The reliance placed on evidence originated by the business for internal purposes is lighter and would be related to the qualtity of internal control. Examples of this evidence are inventory receiving reports and authorizations for bad debt write offs.

6. Evidence obtained by verbal inquiry or by written statements from employees would be considered in view of the circumstances. Such evidence would receive more weight if it confirmed other information than if it stood alone. Examples include confirmation of cash travel advances and estimates of inventory obsolescence.

7. Although it is useful and important, circumstantial evidence would receive the least reliance. Such evidence includes appraisals of the competence of the accounting department and reasonableness of the results of the company's operations as compared to general economic conditions.

c. In evaluating the accounting evidence the CPA views it skeptically and demands, as a test of its credibility, that it persuade him that it supports the facts as he understands them. He judges the evidence by weighing it for pertinence, reliability and conclusiveness.

To be of value the evidence must pertain to the precise issue under consideration. Unwarranted inferences should not be drawn from the evidence. For example, proving the total of a column of figures does not vouch for the veracity of the individual figures. Likewise a bank statement reconcilement verifies the amount of cash in the bank but not the amount that should be in the bank. The significance of the evidence should be understood and improper deductions avoided.

The possibility of misinterpreting the evidence comes to his mind for he knows, for example, that account titles may fail to describe the function or content of the accounts and that the wording of technical agreements is subject to legal interpretation. Consideration is given to the qualifications of the individuals attesting to or confirming the information, for the dependability of such evidence is no greater than that of the person relied upon. The effect of a lapse of time between the date the evidence was compiled and the examination date is evaluated. For example, if the physical inventory is taken prior to the end of the year, the CPA must consider the effect of transactions which occurred in the intervening period. Unconfirmed news stories and common gossip are unacceptable as accounting evidence.

The CPA appraises the conclusiveness of the evidence. He critically reviews evidence that might be incomplete and subject to misunderstanding, asking himself, "Is the evidence useful in its present stage of completeness?" The cost of obtaining more evidence is balanced against the degree of reliance that he can place on the system of internal control. The possibility that his samples are not typical must be carefully weighed. The cumulative or corroborating effect of evidence from two or more sources is in itself a factor that may properly be considered since it increases the probative value of the evidence from each of the sources. Finally, his appraisal of management influences his appraisal of the conclusiveness of the evidence.

Solution 5

a. 1. The primary auditing objective of the independent public accountant is to place himself in a position to express an opinion as to the fairness of the financial statements under examination, their compliance with generally accepted accounting principles and the consistency of the application of these principles with that of the preceding period. A secondary objective is to determine that the objectives (listed below) of the internal auditor are recognized by the client and that suitable progress is being made toward their achievement.

The over-all auditing objective of the internal auditor is to assist management in achieving the most efficient administration of the operations of the organization. This total objective entails the protection of the interests of the organization, including the pointing out of existing deficiencies to provide a basis for appropriate corrective action, and the furtherance of the interests of the organization, including the recommendation of changes for the improvement of the various phases of the operations.

2. In conducting audits the internal auditor appraises company policies, organization, records and performance whereas the independent public accountant is essentially concerned with the verification of accounting data. The internal auditor is charged with the responsibility of seeing that company accounting policies are being followed; he is vitally interested in the cost of prescribed procedures and their effect upon customers and company personnel. By reason of the nature of his work the internal auditor undertakes more exhaustive detailed inquiries than does the outside auditor. Since the independent public accountant has a responsibility to point out areas of possible improvements in the client's procedures, his examination must be made with this additional professional obligation in mind.

For audit purposes the independent public accountant is interested primarily in the end result of the accounting processes but the internal auditor is interested in the processes themselves. The outside auditor proposes correction of errors disclosed by his examination whereas the internal auditor tries to prevent occurrence or recurrence of errors. Both auditors are concerned with the verification of the accuracy of the accounting records. Because he must arrive at a sound basis for the expression of his opinion on the company's financial statements, the independent public accountant is primarily concerned that management accounting decisions conform with generally accepted accounting principles. The internal auditor is aware of this aspect of auditing managerial decisions but principally concerns himself with determining that the decisions promote administrative efficiency and have been complied with.

b. The independent public accountant must evaluate the work of the internal auditor because the latter is an integral part of the system of internal control. Such evaluation is necessary by the outside auditor because its results determine the extent of his auditing procedures.

c. Although the two auditors should co-operate and co-ordinate their efforts, each should maintain his separate identity and the outside auditor should not divulge in advance what activities he will examine or the extent of his examination. The auditing procedures used by an independent auditor in evaluating the work of the internal auditor should include the following:

1. Determine by discussion with him the general competence of the internal auditor, especially his education, amount and type of experience, and general attitude toward his work.

2. Ascertain his degree of independence within the company organization. He should be responsible to an officer of sufficient rank in the organization to assure a broad scope of activities and adequate consideration of and effective action on the findings or recommendations which he makes.

3. Review the internal auditor's audit programs, frequency check-off lists and underlying workpapers to assess the scope and quality of the audit procedures used. His programs should be designed to reveal errors and disclose fraud. The workpapers must show positive evidence of work done. The objective of such review is to acquire sufficient evidential material to form an opinion as to whether the client is being audited effectively.

4. Review projects completed by the internal auditor to determine if they were concerned with essential functions, the comprehensiveness of the report, consequent managerial decision, and followup by the auditor of the managerial decision.

Solution 6

a. The value of $300,000 imputed to the property by the expert appraiser at the same time that such property was acquired at the cost of $100,000 indicates that possibly either the appraisal or the purchase price was unrealistic. A further investigation is necessary to determine which is the case. A CPA must satisfy himself that the expert appraiser's valuations are not arbitrary or capricious. Such valuations should be investigated to determine that they are based on objective valuation criteria.

If the data accumulated, possibly including a second appraisal, indicate that the first appraisal is not reasonable, the CPA must decide whether his opinion should be qualified or adverse, or whether he should disclaim an opinion. He must state the reason for not rendering an unqualified opinion. If the CPA ascertains by accumulation of appropriate data that the valuation of a material asset is not supportable, he may not disregard that fact; an unfair representation in the financial statements is not cured merely by the disclosure of the basis thereof. Under these circumstances not only might it be impossible for a CPA to lend his name to the proposed balance sheet but also dangerous or impudent because of the stock-watering and Blue Sky statutes of the several states.

Furthermore the sale of stock on original issue at a price below par creates the condition wherein the stockholders may be liable to creditors for the difference between the par value and the price paid (not all states permit sale of stock at a discount). In this case it is improper to set up the acquired assets based on the par value of the stock when the same stock is being offered at prices below par at the same time.

On the other hand, should the CPA conclude from his investigations that the value of $300,000 is realistic and that the original price of $100,000 was actually a "bargain purchase," the recording of the asset at a value of $300,000 would have no adverse effect upon his opinion. On the contrary, should the asset be reported at a value of only $100,000 instead of its fair market value of $300,000, the question would be raised whether the financial statements of the new corporation present fairly its financial position. To grossly understate the asset values of the new corporation would be misleading and might be construed as concealing assets.

b. 1. The excess supply of colgum has resulted in an unbalanced inventory. Your determination that the supply will last for three years should be discussed with management. If the quantities and amounts involved are material enough to impair seriously the company's current financial position, full disclosure should be made in the financial statements. Where excess inventory will not be required by the forthcoming operating cycle, such excess quantity, if material, should be reported as a noncurrent asset with an appropriate description. The existence of an unbalanced inventory, if adequately disclosed, would not prevent the CPA from issuing an unqualified opinion.

2. The usual practice is to apply the "lower of cost or market" rule to each individual item of the inventory. However, the "lower of cost or market" rule may also be applied to totals of items that go to make up the same finished product category rather than to the individual items. Under the latter application of the rule the items must be balanced quantities and the rule applied consistently from year to year. Since the excess supply of colgum creates an unbalanced inventory condition, it would be subject to the "lower of cost or market" rule as an individual item rather than as being included in the total of its category.

Solution 7

The Newbold Corporation
WORKSHEET TO ADJUST THE INVESTMENTS ACCOUNT
December 31, 1961

Date 1961	Transactions	Fol	Account per Books Debit	Account per Books Credit	Adjustments: Investments Account Debit	Adjustments: Investments Account Credit	Other Accounts Affected: Account Title	Other Accounts Affected: Debit	Other Accounts Affected: Credit	Investments Account Balance
Jan. 3	Purchased 100 shares, National Motors	CD	$ 4,500			(3) $4,500				
5	Purchased 100 shares, Major Electronics	CD	500			(1) 500	Loss on investments	(1) $ 500		
Mar. 1	Purchased $6,000 City of St. Louis bonds	CD	6,060							$ 6,060*
31	Cash dividend, National Motors	CR		$ 50	(2) $ 50		Dividend income		(2) $ 50	
Apr. 5	Sold 100 shares, National Motors	CR		4,800	(3) 4,800		Gain on sale of investments		(3) 300	
6	Purchased 100 shares, Ace Investment	CD	2,300			(11) 10				2,290
6	Purchased 100 shares General Utility	CD	2,400			(4) 120				2,280
May 1	Received 100 stock rights, General Utility	J	100		(4) 20	(5) 120	Miscellaneous income	(4) 100		
July 2	Purchased 10 shares, General Utility	CD	130		(5) 60		Loss on lapse of stock rights	(5) 60		190
15	Purchased 50 shares, Acme Laboratories	CD	1,900			(10) 18				1,882
18	Purchased 20 shares, The Newbold Corp.	CD	3,000			(6) 3,000	Treasury stock	(6) 3,000		

*The amortization of premiums or discounts on short-term investments is optional.

The Newbold Corporation
WORKSHEET TO ADJUST THE INVESTMENTS ACCOUNT *(Continued)*
December 31, 1961

Date 1961	Transactions	Fol	Account per Books: Debit	Account per Books: Credit	Adjustments — Investments Account: Debit	Adjustments — Investments Account: Credit	Adjustments — Other Accounts Affected: Account Title	Other Accounts Affected: Debit	Other Accounts Affected: Credit	Investments Account Balance
Aug. 15	Sold 10 shares, The Newbold Corp.	CR		1,550	(7) 1,550		Treasury stock		(7) 1,500	
							Premium on reissue of treasury stock		(7) 50	
Sept. 1	Interest on City of St. Louis bonds	CR		90	(8) 90		Interest income		(8) 90	
1	Purchased $10,000 U. S. Treasury bonds	CD	10,067			(9) 67	Interest income	(9) 67		10,000
Dec. 8	Received 2 shares, Acme Laboratories	J	80			(10) 80	Miscellaneous income	(10) 80		
8	Cash dividend, Acme Laboratories	CR		20	(10) 20		Gain on distribution		(10) 2	
15	Cash dividend, Ace Investment	CR		90	(11) 90		Dividend income		(11) 80	
31	Interest on U. S. Treasury bonds	CR		200	(12) 200		Interest income		(12) 200	
31	Cash dividend, General Utility	J	120			(13) 120	Miscellaneous income	(13) 120		
							Dividend receivable	(13) 110		
							Dividend income		(13) 110	
							Accrued interest receivable	(14) 60		
							Interest income		(14) 60	
			31,157	6,800						
	Balance per books			24,357						
			$31,157	$31,157	$6,880	$8,535		$4,097	$2,442	$22,702

The Newbold Corporation
Adjusting Entries
(Not required)

(1)

Loss on investments	$ 500	
Investments—Major Electronics		$ 500

To write off investment in capital stock of Major Electronics. Company was reorganized and capital stock was eliminated.

(2)

Investments	50	
Dividend income		50

To remove cash dividend received from National Motors from Investments account.

(3)

Investments—National Motors	4,800	
Investments—National Motors		4,500
Gain on sale of investments		300

To remove gain on sale of National Motors from Investments account.

(4)

Investments—Stock Rights, General Utilities	20	
Miscellaneous income	100	
Investments—100 shares, General Utilities		120

To allocate cost of rights and to correct entry recording receipt of rights.

Cost of Rights

$$\frac{1}{\$19 + \$1} \times \$2{,}400 = \$120$$

(5)

Investments—10 shares, General Utilities	60	
Loss on lapse of stock rights	60	
Investments—Stock Rights, General Utilities		120

To allocate cost of stock rights exercised and to record loss on lapse of rights.

Rights exercised = 50/100 × $120 =	$ 60
Rights lapsed = 50/100 × $120 =	60
Total cost of rights	$120

(6)

Treasury stock	3,000	
Investments—20 shares, The Newbold Corp.		3,000

To remove treasury stock purchased from the Investments account.

(7)

Investments—10 shares, The Newbold Corp.	1,550	
Treasury stock		1,500
Premium on reissue of treasury stock		50

To remove sale of treasury stock from the Investments account.

(8)

	Debit	Credit
Investments	90	
Interest income		90

To remove interest received on City of St. Louis bonds from Investments account.

(9)

	Debit	Credit
Interest income (or receivable)	67	
Investments—U. S. Treasury bonds		67

To remove interest purchased from the Investments account.

(10)

	Debit	Credit
Miscellaneous income	80	
Investments	20	
Investments		80
Investments—Acme Laboratories		18
Gain on distribution		2

To remove valuation placed on 2 shares Acme Laboratories stock received as stock dividend and to correct the recording of the cash dividend received in lieu of a fractional share. The cash received was, in part, a reduction of the stockholder's equity.

Computation of Gain on Distribution

Cash received	\$20
Cost of ½ share	18
$(\frac{1}{2} \times \frac{\$1,900}{52.5} = \$18.10)$	
Gain on distribution	\$ 2

(11)

	Debit	Credit
Investments	90	
Dividend income		80
Investments—Ace Investment		10

To remove dividend income from Investments account and to record return of capital invested in Ace Investment.

(12)

	Debit	Credit
Investments	200	
Interest income		200

To remove interest received on U. S. Treasury bonds from Investments account.

(13)

	Debit	Credit
Miscellaneous income	120	
Dividend receivable	110	
Investments		120
Dividend income		110

To correct accrual of dividend receivable from General Utility.

(14)

	Debit	Credit
Accrued interest receivable	60	
Interest income		60

To record accrued interest on City of St. Louis bonds (4/12 × 3% × \$6,000 = \$60).

COMMERCIAL LAW

November 9, 1962; 8:30 a.m. to 12:00 m.

Solution 1

1. True
2. False
3. False
4. True
5. False
6. False
7. False
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9. False
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18. True
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Solution 2

76. True
77. True
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87. True
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144. True
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147. True
148. False
149. True
150. False

Solution 3

151. True	166. True	181. True	196. True	211. False
152. True	167. True	182. False	197. True	212. False
153. False	168. False	183. True	198. True	213. True
154. False	169. False	184. True	199. True	214. False
155. False	170. True	185. False	200. False	215. True
156. False	171. True	186. False	201. False	216. False
157. False	172. False	187. False	202. True	217. True
158. True	173. True	188. True	203. True	218. False
159. False	174. False	189. False	204. True	219. False
160. False	175. False	190. False	205. True	220. False
161. False	176. True	191. True	206. False	221. True
162. False	177. True	192. True	207. True	222. False
163. False	178. True	193. True	208. True	223. True
164. False	179. False	194. True	209. True	224. True
165. True	180. True	195. True	210. True	225. True

Solution 4

a. 1. Yes. A "without recourse" indorsement is a qualified indorsement but does not, in and of itself, impair the indorsee's taking in good faith or otherwise satisfying all the requisites of a holder in due course.

2. Yes. The bank had given value based upon the application of the FIFO rule to the depositor's account. The $1,500 which Carl deposited would, under the FIFO rule, be deemed to have been withdrawn when the check for $10,000 was paid by the National Bank. The $3,000 balance in his account represented the residue of the $7,000 deposit he made the day after he deposited the $1,500.

3. The bank could assert the rights of the prior holder in due course; i.e., the rights of Carl, its depositor. Although one may not be able personally to qualify as a holder in due course he may assert the right of, i.e., stand in the shoes of, a prior holder in due course provided he is an innocent party with regard to the original fraud.

b. The impostor rule relates to the fraudulent obtaining of a negotiable instrument by impersonating another party. If the impersonation is made in the presence of the party defrauded the courts have held that the party receiving the instrument can validly sign the name of the party he impersonated to negotiate the instrument to a holder in due course. The effect of this rule is to eliminate the assertion of the real defense of a forged indorsement by the maker or drawer. Some courts have held that the impersonation may occur outside the presence of the party defrauded and still permit the impostor to validly sign the impersonated party's signature. Other courts apply the rule only in situations where the fraud occurs in the defrauded party's presence.

Solution 5

a. 1. No. The term merchantable quality means the fair average quality of such goods in the existing market. Some of the criteria used would be whether the goods

(a) Pass without objection in the trade.
(b) Are of fair average quality compared with like goods.

(c) Are fit for the ordinary purposes for which such goods are used.
(d) Are adequately contained, packaged and labeled as the agreement may require or as is the custom with like goods.

2. Yes. Although acceptance does not bar an action for breach of warranty, the buyer's failure to give notice to the seller of the breach of any promise or warranty within a reasonable time after the buyer knows of such breach will free the seller from such liability. Here the breach of warranty was quickly discovered but the buyer waited six months before giving notice. Such notice was not given within a reasonable time.

3. Where there is a breach of warranty by the seller, the buyer may
(a) Accept or keep the goods and set up the breach of warranty by way of recoupment in diminution or extinction of the price.
(b) Accept the goods and sue for damages for breach of warranty.
(c) Refuse to accept the goods, if title has not passed to him, and sue for damages for breach of warranty.
(d) Rescind the contract to sell or the sale and refuse to receive the goods, or if the goods have been received, return them or offer to return them and recover the price or any part thereof that has been paid.

b. A sale of goods is defined as "an agreement whereby the seller transfers property in the goods (title) to the buyer for a consideration called the price." A trust relationship represents the transfer of legal title to property, real or personal, tangible or intangible, to a trustee to hold, use and manage for the benefit of a third party, called the beneficiary, who has the beneficial or equitable ownership of the property.

From these definitions it is apparent that a sale of goods encompasses only tangible personal property whereas a trust may relate to virtually any type of property. Secondly, in a trust a split of legal and equitable title exists, whereas in a sale, title usually passes absolutely to the purchaser. Finally, the buyer may generally do what he wishes with the property because it is his, whereas the trustee must manage and use the property for the benefit of the beneficiary to whom he owes an obligation.

Solution 6

a. The majority of jurisdictions regard preincorporation subscriptions as continuing offers to the corporation. The subscription is binding upon acceptance by the corporation; acceptance by the corporation takes place either at the time of incorporation without further action by the corporation, or upon incorporation and the board's acceptance of the subscriptions.

b. Yes. A preincorporation contract made by a promoter for and on behalf of the corporation is not binding upon the corporation unless it adopts the contract. The promoter is acting for a nonexistent principal and therefore the corporation is not bound at the inception of the contract. It can treat the lease as an offer which it may adopt or reject. Here the corporation has validly rejected the lease of office space.

c. Yes, he is liable on both leases. Since Peter was acting as an agent for a nonexistent principal, Peter is liable. The basic rule of agency is that an agent acting for a nonexistent principal is, in effect, acting in his own behalf.

d. Yes. An acceptance of the offer may be made by an express or implied adoption. In this case the board, by voting to move the machinery into the plant and subsequently doing so, would be deemed to have impliedly accepted the contract, i.e., by taking the benefits they have assumed the liabilities.

e. No. Even though there is a subsequent adoption of the contracts made by the promoter, he remains liable unless there is a novation.

f. The unsatified creditors of the corporation can recover from the shareholders for the difference between par value and the amount actually paid, i.e., $25 per share. The creditors supposedly rely upon the par value, which represents the legal capital, in determining how much to lend the corporation. Therefore, such creditors can collect either on the reliance theory or upon the statutory imposition of liability for payment of less than par for par value stock.

g. No. A *bona fide* purchaser from the subscriber of stock issued for less than par has no liability to creditors. He would be liable only if he knew of the original payment for less than par.

Solution 7

a. 1. *The Advertisement.* This was an invitation to do business and not an offer. It has no binding effect upon the advertiser and cannot be accepted. Its purpose is to solicit offers.

2. *The Baker telegram of September 18th.* This was an offer to purchase the indicated quantity of beer at stated prices. It was effective as an offer upon receipt. It could then be accepted or rejected by the Brand X Beer Company.

3. *Brand X's night letter.* Although purporting to be an acceptance the night letter was clearly a rejection of the Baker offer and, in effect, a counteroffer. To be effective, an acceptance must be unequivocal and must not change or modify the terms of the offer. In this case there were changes in quantities. The counteroffer was not effective until received.

4. *The Baker telegram of September 19th.* This was an acceptance and was effective upon delivery to the telegraph office (11:16 a.m.) provided it was sent within a reasonable time and was unconditional (see part "b").

5. *The Brand X Telegram of September 19th.* This constituted an attempted revocation of the counter offer made by Brand X in their telegram of the 18th. Revocations are not effective until received. In addition, it had, of course, no legal effect upon Baker's offer of September 18th.

b. Yes. The Brand X telegram of the 18th coupled with Baker's telegram of the 19th constituted an offer and acceptance. Where, as in this case, the offeree uses the same means of communication used by the offeror, the acceptance is effective at the time of delivery to the agency for transmission. Since a revocation is not effective until received, the purported revocation was too late because it was not received until 11:46 a.m. whereas the acceptance was effective at 11:16 a.m. The question of reasonableness of time would be decided in favor of Baker because the word "immediately" here obviously was interpreted by both parties as meaning within several hours. The change involving the request that the papers be forwarded to the First City Bank would not be such as to warrant the finding of a modification so as to constitute a rejection.

c. The standard contract measure of damages would appear to be applicable here, i.e., the difference between the fair market value at the time of breach ($9 and $11 per barrel) and the contract price ($8 and $10 per barrel). The damages would be $57.

Solution 8

a. Yes. Although the torrential rains and resultant flooding would be considered as an act of God and, thereby, ordinarily free the common carrier from its insurer's liability, the carrier is liable since it was its error which caused the delay. Under these circumstances the defense of an act of God will be unavailable.

b. 1. The goods are not of the type that the carrier transports.
2. The goods are not properly packed.
3. The goods are of an inherently dangerous nature.
4. The carrier demands payment in advance and the shipper refuses to pay.
5. The shipper designates a route which is not usual or customary.
6. The carrier's facilities are fully engaged.

c. According to the Carmack amendment to the Interstate Commerce Act, the connecting carrier is the agent of the initial carrier and is liable to the shipper for loss on its lines. The initial carrier is liable to the shipper for loss on its own lines and those of the connecting carrier. However, the initial carrier can sue and collect damages caused by the connecting carrier. This, in effect, is an example of the right of subrogation.

Solution 9

a. 1. The "Rule of Reason" is a general, court-imposed standard used to test the legality of an alleged violation of Section 1 of the Sherman Act. In effect, it allows the court to test the reasonableness of the restraint in relation to the particular facts of each case rather than applying a specific test or holding that all restraints are illegal which the plain meaning of the statute would apparently indicate. The Supreme Court by use of the "Rule of Reason" has, in effect, amended the statute by the insertion of the word "unreasonable" before "restraint" in the statute.

2. No. Although the "Rule of Reason" applies to most restraints of trade, price fixing and the variations thereof are deemed to be illegal *per se*, i.e., there can be no showing of reasonableness since price fixing is deemed unreasonable and, therefore, unjustifiable.

b. 1. A horizontal integration is one involving the purchase, merger or consolidation of competing business entities. For example, two competing automobile or steel manufacturers merge.

A vertical integration represents a purchase, merger or consolidation of a buyer by a seller or vice versa. For example, a maker of automobiles purchases a corporation that makes automobile batteries or an oil company purchases gasoline service stations.

A conglomerate integration occurs when entities wholly unrelated as to competition or use of products are joined or merged to form one large diversified entity. For example, the purchase of an electronics company by a textile manufacturer.

2. The Sherman and Clayton Acts.

THEORY OF ACCOUNTS

November 9, 1962; 1:30 p.m. to 5:00 p.m.

Solution 1

1. C
2. A
3. C
4. A
5. C
6. E
7. A
8. D
9. B
10. C
11. B
12. B
13. B
14. B
15. C

Solution 2

a. 1. Depreciation is the accounting procedure that allocates the cost or other basic value of a depreciable asset over its estimated useful life. The objective is to systematically and rationally apportion the cost of the asset to each of the periods benefited by its use. As a result the amount of the unallocated cost of the asset is reported in the balance sheet.

2. In lieu of recording depreciation on replacement costs management might elect to make annual appropriations of retained earnings in contemplation of replacing certain facilities at higher price levels. Such appropriations might help to eliminate misunderstandings as to amounts available for distribution as dividends, higher wages, bonuses or lower sales prices. The need for these appropriations can be explained by supplementary financial schedules, explanations and footnotes accompanying the financial statements.

b. Financial statements developed in terms of uniform "current" dollars might serve the following purposes:

1. An appraisal of the company's earning power in relation to current economic conditions.

2. A common denominator for negotiations with labor unions and for establishment of sound wage policies.

3. A guide to government policies and decisions regarding economic controls by means of price regulation, limitation of profits, taxation and monetary policy.

4. The guidance of the general public to an understanding of the effect of inflation or deflation upon profits, prices, wages and financial relationships in general.

5. An aid to management in the determination of policies regarding pricing, financing, dividends, expansion, etc.

6. A means for the investor to compare the results of current operations with prior years and with the operating results of competitors established or acquiring assets under varying economic conditions.

Solution 3

a. The knowledgeable reader attempts to draw conclusions from the interim statements regarding

1. The results of current operations.
2. The current position.
3. The results which will be reported in the annual report.
4. The future prospects.
5. The effect of seasonal business fluctuations on the company's operations.
6. The cash requirements, and
7. The trend of company operations and profits by comparison with the statements for prior periods.

b. 1. Sales data should not be altered or modified. Readers attach precise implications to sales data and compare them with other periods. To alter the sales data would destroy their interperiod comparability. Furthermore, an objective basis does not exist for the deferral or accrual of sales. Nonseasonal fluctuations in sales cannot be isolated with exactness from seasonal fluctuations. An unusual variation from the sales pattern might be brought to the reader's attention in the commentary accompanying the statements.

2. Consideration should be given to modifying manufacturing costs to reduce intrayear fluctuations and to avoid placing the burden of any cumulative cost variances in the final period of the year. Such modification would involve distinguishing between costs that are fixed, those that vary with the season, and those that vary with production. Fixed costs should be prorated equally over the interim statements. Seasonal costs, such as vacation pay or major annual maintenance, should be apportioned over the interim statements on the basis of the activities which give rise to them. The proration of production costs should be based upon production. Any cost variance arising from waste, inactivity or extravagance should be written off in the period incurred.

A balance may occur in the over- or underabsorbed overhead accounts where overhead is assigned to period expense by a predetermined burden rate and factory costs are fixed or vary with production or the season. Showing this balance in the interim balance sheet reduces fluctuations in reported income for the first three quarters but may place a heavy adjustment in the last quarter. But to show the balance in the quarterly income statement accentuates fluctuations in reported income as conditioned by the interrelationships of seasonal variations in sales, production and costs. Accordingly the interim income statement should be relieved of seasonal variances which are expected to be offset in the remaining portions of the year; other variances should be carried to the income statement.

3. Modification of selling expenses for interim statements merits consideration. Management has some control over the expenses and can forecast deviations through the budget. Moreover, expenses do not have the connotation of preciseness that sales do because readers are aware that many companies make intrayear expense distributions.

In making a modification a distinction should be made between expenses that are fixed and those that vary with sales volume. Fixed expenses should be expensed by equal periodic apportionment. The charge for variable expenses should be based upon their expected relationship to sales volume for the year.

The treatment of advertising expense should be dependent upon whether it is a fixed expense or determined by sales volume. Where advertising is fixed by a relatively inflexible budget and there is little correlation between sales and advertising expenditures in a given period, equalization of the expense appears to be in order. Conversely, when advertising has a direct relation to sales volume and is subject to managerial decision in light of current market conditions, there is little justification for equalization of the expense.

Solution 4

a. The objectives of the application of generally accepted accounting principles to the income statement are to measure and report the results of operations as they occur for a specified period without recognizing any artificial exclusions or modifications.

The basic objectives of income tax laws are to provide revenue for the operation of the government and to regulate the economy. In attaining these objectives the income tax laws provide for the determination of taxable income in accordance with legal provisions which are administratively workable.

b. The differences arising from the specifications of the tax laws are characterized as being either special concessions of the taxing authority to selected groups of taxpayers or the limitation or denial of deductions. Special concessions might concern either revenues or deductions. With regard to revenue, for example, income tax laws have specified that interest received on certain types of bonds should be excluded from taxable income, but this interest is included as income in financial statements. Selected groups have received special concessions for deductions, such as percentage depletion, which have no counterpart under accounting convention. Income tax laws limit or deny, for tax purposes, deductions that are expenses under conventional accounting. The limitation imposed by tax law may be exemplified by the percentage limitation on charitable contributions. An example of a denied deduction would be a contribution for political campaign purposes.

Although financial accounting and tax laws might concur on the items to be recognized as revenue and expense, timing differences arise because there is disagreement as to the period in which the items are to be recognized. The differences caused by specifications of tax laws are absolute or final whereas the differences caused by timing will eventually disappear because, over a period of years, the revenues or expenses determined under both accounting methods tend to total to the same amount. The differences in timing can be analyzed as follows:

1. The accounting method adopted for income tax purposes may be dif-

ferent from the method used in the financial statements. Such difference would arise from a managerial decision and can be exemplified by differences in depreciation methods.

2. Rules regarding revenue and expense are not in accord in all respects under both methods of accounting. For example, provision for losses under product warranties can be made in the year the product is sold under conventional accounting but only payments for such warranties are deductible under income tax law.

3. Generally accepted accounting principles provide that extraordinary items of material amount should be reported in the statement of retained earnings instead of the income statement; such extraordinary items might be included in the computation of taxable income.

c. The arguments against including Deferred Income Taxes as a part of the stockholders' equity include the following:

1. The costs deducted in a period help to determine taxable income and income taxes payable. When the costs deducted under tax accounting are greater than those under conventional accounting, the financial net income would be distorted if the tax effect of the difference between the two accounting methods is not recognized; the costs of income taxes would not be matched with revenues of the period.

To prevent distortion of financial net income the amount of the deferred income taxes is charged against revenues in the early years and returned to income in later years when the amount of the deduction under conventional accounting exceeds the deduction under tax accounting. Deferred income taxes, therefore, might be considered as taking the form of a deferred credit to income which is customarily reported on the liability side of the balance sheet under a nonequity caption.

2. The difference in reported income for income tax accounting and conventional accounting purposes results in a liability for future income taxes payable. The obligation is owed in the sense that the income giving rise to the obligation has been earned, but it is not reported for tax purposes until the deductions available under income tax accounting are exhausted. The recognition of this obligation as a liability is also consistent with accrual accounting which recognizes future obligations arising from current transactions. Since deferred income taxes are a liability, the account is properly excluded from the stockholders' equity.

3. The deferred tax account arises as a result of reducing earnings by providing for the deferred tax expense. Therefore to classify deferred taxes as a reservation or portion of retained earnings is unreasonable because retained earnings cannot be increased by decreasing earnings.

4. Furthermore to consider the deferred tax account as a form of contributed capital that was contributed by the government is also unreasonable. Contributed capital must be permanent in nature whereas the deferred taxes are akin to a long-term loan.

5. Under certain conditions deferral of the recognition of income taxes results in an account with a debit balance which can only be reported as an asset. There is no accounting justification for deducting this asset from the stockholders' equity. Deferred income taxes with a credit balance, it follows, should receive comparable treatment by being excluded from the stockholders' equity section.

6. If the deferred income taxes arise from a difference in rates of depreciation, the account may be interpreted to be a valuation account. The value of a depreciable asset arises from two sources. The asset has value as a productive unit for the use of which depreciation is recorded under conventional accounting, and it has value as an income tax deduction for which depreciation is claimed under income tax accounting. It is an accepted accounting procedure to combine the amounts of the conventionally accumulated depreciation and the related deferred income taxes (or loss of future deductibility) as one figure in the financial statements. Since deferred income taxes arising from differing depreciation methods serves as a valuation account, it should be excluded from the stockholders' equity.

Solution 5

a. Arguments for the use of the LIFO method of valuing inventory include the following:

1. During periods of changing price levels LIFO provides a means of approaching a matching of current costs with current revenues.
2. By matching rising costs with rising sales prices in periods of rising prices, and conversely, matching declining costs with falling sales prices in periods of falling prices, LIFO results in relatively steady gross profit percentages and thus tends to smooth the peaks and valleys of reported income.
3. LIFO avoids recognition of a "paper" profit or loss on the company's investment in inventory which as a going concern it must continue to own.
4. By bringing reported income more nearly into line with the disposable cash arising from operations the use of LIFO assists the firm to retain the number of dollars required to maintain the inventory and other resources of the enterprise as they stood at the beginning of the year.
5. In more closely matching reported income with disposable cash the use of LIFO assists management in such functions as dividend declarations and union negotiations.
6. In a period of rising prices an income tax savings results in the year of adoption of LIFO. Subsequent income tax effects are dependent upon future price levels, tax rates, variations in the kinds and amounts of inventory, sources of income from other than inventory profits and losses, and the operation of such tax averaging devices as loss carry-backs and carry-overs.
7. Where tax assessors are guided by book values, a savings of personal property taxes will ensue when the price level rises after adoption of LIFO.
8. The LIFO method is similar to management's viewpoint since management tends to think in terms of margins between current sales prices and current costs of sales. Furthermore relating current costs of sales to current sales prices tends to call management's attention to any shrinkage in profit margins and to the necessity for revising sales prices.

Arguments against the use of the LIFO method of valuing inventory include the following:

1. Since the inventory is valued at noncurrent historical costs, the balance sheet is less meaningful and financial ratios concerning working capital and inventory turnover are distorted.
2. The LIFO cost flow assumption is not realistic because it is not in accordance with the actual physical flow of goods in most instances.

3. Because LIFO methods are difficult to apply, especially to perpetual inventories, it might be desirable to resort to other pricing methods for interim statements and apply LIFO only to the end-of-period statements.

4. When LIFO inventories are liquidated involuntarily in a period of rising prices the income reported is higher than under any other pricing method unless a Reserve for the Replacement of LIFO Inventory account is established.

5. LIFO is not universally applicable because some businesses, by nature, cannot achieve the stability of inventory levels essential to its effective operation.

6. LIFO results in an artificial statistical smoothing of income. Inasmuch as certain businesses are subject to yearly fluctuations in their operations, the introduction of a device to obscure this condition should not be encouraged.

7. In a period of sharply rising prices a shift to LIFO, with its lower reported profit and working capital, might result in defaults under loan or bond contracts and other special agreements.

b. The dollar-value method of LIFO inventory valuation is a procedure using dollars instead of units to measure increments or reductions in a LIFO inventory. The method presumes that goods in the inventory can be classified into pools or homogenous groups. After the grouping into pools the ending inventory is priced at the end-of-year prices and a price index number applied to convert the total pool to the opening inventory price level. Such a price index might be obtained from government sources, if available, or computed from the company's records. The pools or groupings of inventory are required where a single index number is inappropriate for all elements of the inventory.

After the closing inventory has been placed on the same price level as the opening inventory, any difference between the two inventories is attributable to an increase or decrease in inventory quantity at the base year price. An increase in quantity so determined is converted to the current year price level and added to the amount of the opening inventory as a separate inventory layer. A decrease in quantity is deducted from the opening inventory at the base year price level.

The advantages of the dollar-value method over the quantity LIFO method are as follows:

1. The application of the LIFO method is simplified because, under the pooling procedure, it is not necessary to match opening and closing quantities of individual items. As a result, companies with inventories comprised of thousands of items may adopt the LIFO method.

2. Base inventories are more easily maintained. The pooling method permits greater flexibility because each pool is made up of general types or styles of inventory rather than specific manufactured parts or items of raw material. In a business with changing products some portion of the pool might be entirely replaced with other products of like kind without disturbing the base layer of the pool.

Solution 6

a. Direct costing is an accounting concept based on the division of operating costs (production, selling and administrative) into two fundamental types, fixed and those varying directly with volume. In valuing inventory and determining the cost of sales only prime costs and variable manufacturing costs are used. Fixed costs are charged to income in the period of their occurrence. This accounting concept is also termed "variable costing" because only the variable costs are charged to the product. The concept of direct costing may be applied to either process or job-order cost systems and standard costs may or may not be employed; direct costing is not a complete costing system.

Conventional absorption costing and direct costing differ in a number of ways:

1. Accounting for direct labor and direct material is the same under both methods but the segregation of overhead into fixed and variable is seldom found in the absorption costing accounts.

2. Another difference is the order in which costs are applied against income. Absorption costing distinguishes between the costs of production and other costs; all production costs are first deducted from sales to arrive at an interim figure called gross profit and then other costs are deducted to obtain net profit. Under direct costing, prime costs and all variable costs and expenses, including nonmanufacturing expenses, are applied first against income to arrive at the interim figure, marginal income, from which are deducted all classifications of fixed costs to determine net profit.

3. Fixed factory overhead costs are charged to inventory and cost of goods sold under absorption costing but under direct costing fixed factory overhead costs are charged as a period cost and are not inventoried. The difference in net income under these two methods is an amount equal to the change in the amount of fixed overhead capitalized in inventory under absorption costing.

4. Although the income computed for a short period might differ under the two costing concepts, such divergence would tend to disappear over a longer period because differences between production and sales volume tend to approach equality.

b. Arguments for the use of direct costing include the following:

1. For profit planning purposes management requires cost-volume-profit relationship data which are more readily available from direct cost statements than from absorption cost statements.

2. Inasmuch as fixed expenses are absorbed consistently as a period cost and are not inventoried, increasing or reducing the inventory does not affect the profit for the period.

3. Direct cost reports are more easily understood by management because the statements follow management decision-making processes more closely than do absorption cost statements.

4. Reporting the total fixed costs for the period in the income statement directs management's attention to the relationship of these costs to profits.

5. The elimination of allocated joint fixed costs permits a more objective appraisal of income contributions according to products, sales areas, kinds of customers, etc. Cost-volume relationships are highlighted.

6. The similarity of the underlying concepts of direct costing, flexible budgets, breakeven analysis and standard costs facilitates the adoption and use of these methods for reporting, cost control and financial planning.

7. Direct costing provides a means of costing inventory that is similar to management's concept of inventory cost as the current out-of-pocket expenditures necessary to produce or replace the inventory.

8. Clerical costs are lower under direct costing because the method is simpler and does not require involved allocations of fixed costs or special analyses of absorption data.

9. The computation of product costs is simpler and more reliable under direct costing because a basis of allocating fixed costs, which would involve estimates and personal judgment, is eliminated.

10. A "true and proper" profit results from direct costing because only variable costs should be identified with production. Fixed costs are the expenses of maintaining productive capacity, and such expenses occur with the passage of time and not with the utilization of the facilities.

Arguments against the use of direct costing include the following:

1. Separation of costs into fixed and variable costs might be difficult, especially when such costs are semivariable in nature. Moreover, all costs—including fixed costs—are variable at some level of production.

2. Long-range pricing of products and other long-range policy decisions require a knowledge of complete manufacturing cost which would require additional separate computations to allocate fixed overhead.

3. The pricing of inventories by the direct costing method has not been accepted for income tax computation purposes; supplementary computations using an acceptable method are required.

4. The cost method of direct costing has not been recognized as conforming with generally accepted accounting principles applied in the preparation of financial statements for stockholders and the general public.

5. Profits determined by direct costing are not "true and proper" because of the exclusion of fixed production costs which are a part of total production costs and inventory. Production would not be possible without plant facilities, equipment, etc. To disregard these fixed costs violates the general principle of matching costs with revenues.

6. The elimination of fixed costs from inventory results in a lower value and consequent reduction of reported working capital for financial analysis purposes.

c. 1. The same net profit is arrived at under both costing methods when sales and production are in balance at standard volume.

2. Direct costing yields a greater net profit than does absorption costing when sales exceed production.

3. Absorption costing shows a greater net profit than does direct costing when production exceeds sales.

Solution 7

a. Costs should be recognized as expiring in a given period if they have not been chargeable to a prior period and are not applicable to future periods. Recognition in the current period is required when any of the following conditions or criteria are present:

1. A direct identification or association of charges with revenue of the period, such as goods shipped to customers.

2. An indirect association with the revenue of the period, such as fire insurance or rent.

3. A measurable expiration of asset costs during the period, even though not associated with the production of revenue for the current period, such as a fire or casualty loss.

b. 1. Cash discounts on purchases are treated as "other income" in many financial statements in violation of the matching concept. Income is not realized when goods are purchased or cash disbursed. Furthermore inventories valued at gross invoice price are recorded at an amount greater than their cash outlay resulting in misstatement of inventory cost in the current period and inventory cost expirations in future periods.

Close adherence to the matching concept requires that cash discounts be recorded as a reduction of the cost of purchases and that inventories be priced at net invoice prices. Where inventories are priced at gross invoice prices for expediency, however, there is slight distortion of the financial statements if the beginning and ending inventories vary little in amount.

2. The valuation of inventories at the lower of cost or market has been widely adopted as a conservative method of valuing inventories. This method results in recording losses but not profits prior to the sale of the inventory. Where there is not an attendant drop in sales prices, costs and revenues are mismatched to the extent that the present period's reported profits are reduced and the next period's reported profits are increased. Such mismatching has been justified on the grounds that the next period should receive a "fresh start" and its position be the same as though the inventory had been purchased at current market prices. This argument, it has been pointed out, is contrary to the "going concern" concept.

Where the writedown is of substantial amount, it has been suggested that the cost of goods sold be reported in terms of original cost. The writedown would be excluded from the cost of goods section and shown separately as an extraordinary period cost. In addition to matching costs with revenues, this procedure shows normal and abnormal operating results on the income statement for comparative purposes.

3. Although it is generally agreed that inventory costs should include all costs attributable to placing the goods in a salable state, receiving and handling costs are often treated as cost expirations in the period incurred. The resultant mismatching is intensified where these costs are incurred irregularly or are not in uniform proportion to sales.

The portion of the receiving and handling costs attributable to the unsold goods processed during the period should be inventoried. These costs might be more readily apportioned if they are assigned by some device such as an applied rate. Abnormally high receiving and handling costs should be charged off as a period cost.

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